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T. C. Memo. 1986-213

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UNITED STATES TAX COURT

EDGAR REED II AND MARY JANE REED, Petitioners
v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 3706-83. Filed May 27, 1986.

Held: Petitioners' theft loss deduction determined; deduction for "lost use" of funds and loss of anticipated income denied; and petitioners' deduction for attorney fees paid in connection with grand jury investigation allowed.

Edgar Reed II, pro se.

Albert A. Balboni, for the respondent.

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MEMORANDUM OPINION

WHITAKER, Judge: Respondent determined a deficiency of $300 in 1980 resulting from disallowance of a $1,371 theft loss deduction claimed by petitioners.[1] By amended petition, petitioners claimed increased casualty and theft loss deductions in excess of $13,000, a deduction for 7-1/2 years "lost use" of funds which petitioner's former employer failed to pay promptly under a profit-sharing and retirement plan, and a deduction for loss of anticipated income resulting from petitioner's former employers' refusal to pay the amounts purportedly required under a 1969 "key management" agreement. Petitioners' entitlement to each of these deductions is in issue. Additionally, whether petitioners are entitled to a deduction for attorney's fees of $1,211.20 paid during 1980 was placed in issue during trial.

For convenience, our Findings of Fact and Opinion are combined. Some of the facts have been stipulated and are so found. The stipulations of fact and attached exhibits are incorporated herein by this reference. Petitioners resided in Worcester, Massachusetts, when their petition was filed.

The alleged casualty and theft losses arose from petitioner's drawn out and acrimonious dispute with Reed & Prince Manufacturing Company (Reed & Prince). These losses relate to three categories of personal property: (1) property removed from petitioner's office in 1976; (2) property which was the subject

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[1] Mary Jane Reed is a petitioner in this case solely by virtue of having filed a joint Federal tax return with Edgar Reed II for 1980. As used herein, "petitioner" refers to Edgar Reed II.

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of a state action instituted by petitioner against Reed & Prince in 1980; and (3) property which petitioner, in 1980, discovered had been lost while stored on Reed & Prince's business premises but which was not the subject of his state action.

Petitioner was first employed by Reed & Prince, a family business manufacturing screws, nuts, and bolts, in 1946. He became president of Reed & Prince in 1963 and remained so until removed from office on April 5, 1976. Petitioner and/or his family were major shareholders of Reed & Prince throughout this period and petitioner served as a director even after he had been replaced as president.

In 1974, pursuant to action by the Board of Directors, a large amount of Reed & Prince stock was sold to four top managers. This resulted in a shift to these individuals of control of Reed & Prince. Thereafter, these managers tried a number of techniques to force petitioner out of the business and to persuade him to sell his stock. These techniques included locking him out of his office for a brief time in February 1976 and, on March 30, 1976, permanently evicting him from his office and removing the contents of said office, including certain personal property and records, to an unknown location. Despite repeated requests for his office possessions, with the exception of some records returned in September 1978, petitioner was unable to recover the items removed from his office. Petitioners claimed a loss on their 1980 return for a desk, antique cupboard, and an antique photograph of the founder of Reed & Prince which

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were removed from petitioner's office in 1976. At the time of trial, petitioner had been advised by the individual who had replaced him as president of Reed & Prince that the antique photograph was in the corporate offices but would not be turned over to petitioner until he offered some proof of ownership.[2] Petitioner did not know what had happened to the desk and antique cupboard, i.e., if they were also in Reed & Prince's possession. As each of these items had assertedly been inherited, petitioner, through conversations with his lawyer, estimated the amount of theft loss attributed to them to be $500.

We sustain respondent's disallowance of a theft loss deduction in 1980 representing the desk, antique cupboard, and antique photograph. As a predicate to any theft loss, a taxpayer must prove he was the owner of the property stolen. Draper v. Commissioner, 15 T.C. 135 (1950); Lupton v. Commissioner, 19 B.T.A. 166 (1930).[3] The current management of Reed & Prince apparently challenge petitioner's ownership of these items and petitioner failed to offer any proof that he had, in fact, inherited these antiques. Even if we ignore this shortcoming, petitioner would not be entitled to a theft loss deduction for these items in 1980. In the case of a theft loss, a taxpayer is

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2 Petitioner asserts that because his personal records were included in the materials appropriated from his office at Reed & Prince, he is unable to substantiate his ownership of any of the items for which he claims a loss.

3 Jensen v. Commissioner, T.C. Memo. 1979-379; Silverman v. Commissioner, T.C. Memo. 1975-255, affd. without published opinion 538 F.2d 320 (3d Cir. 1976); Whiteman v. Commissioner, T.C. Memo. 1973-124.

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entitled to a deduction in the year in which the theft is discovered. Sec. 165(e);[4] sec. 1.165-1(d)(3), Income Tax Regs. If Reed & Prince's removal of the desk, cupboard, and photograph from petitioner's office in 1976 constituted a theft, the appropriate year to claim a deduction was 1976 rather than 1980. As petitioner was present when the appropriation of his office furnishings occurred, he was indisputedly aware of the "theft" in the earlier year. As a final basis for disallowing any deduction for these items, petitioner has failed to carry his burden of proving his basis in the purportedly stolen property. To qualify for a theft loss deduction, a taxpayer must establish his basis in inherited property before such loss can be determined. United States v. Lattimore, 353 F.2d 379, 381 (9th Cir. 1965). Petitioner has failed to do so.

During the 30 years petitioner was employed by Reed & Prince, he stored various items of personal property on the company's premises including an antique racing car and trailer, two antique electric trucks, various automobile parts and accessories, e.g., four tires, and other miscellaneous items. When petitioner's employment with Reed & Prince ended in 1976, these items were stored in an unused area in the top floor of the company's plant. Sometime between petitioner's termination as an officer and employee and early 1980, petitioner's personal property was moved from storage in the plant building to a shed

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[4] All section references are to the Internal Revenue Code of 1954, as amended and in effect during the years in issue.

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in the plant yard and, shortly thereafter, to a loading platform where it was subject to damage from exposure to the elements, vandalism, and/or theft. During this period, petitioner made numerous demands on the directors of Reed & Prince and in shareholder meetings for the return of his personal property. These demands were ignored and petitioner took no other formal or informal action to retrieve his property.

On March 29, 1980, petitioner and his attorney were permitted to return to Reed & Prince's premises to retrieve his personal property. They discovered that the antique car was severely damaged due to exposure and vandalism and other items were similarly damaged or missing. On April 6, 1981, petitioner instituted a civil action in state court against Reed & Prince seeking a judgment of $15,000 as recompense for damage to and loss of specified items of personal property. On June 20, 1983, judgment was entered for Reed & Prince based on the finding that, although at some time during the 4-year period that petitioner's personal property was stored on Reed & Prince's premises it was damaged or disappeared, there was no agreement as to storage and Reed & Prince had violated no duty owed to petitioner. Petitioner's appeal was pending at the time of trial. The casualty and theft loss deductions petitioner now claims include those items of personal property which are the subject of that appeal.

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As petitioners correctly noted on the attachment to their 1980 return, deduction for casualty and theft losses for the items of personal property which were the subject of the state suit could not be claimed. "[N]o portion of the loss with respect to which reimbursement may be received is sustained * * * until the taxable year in which it can be ascertained with reasonable certainty whether or not such reimbursement will be received." Sec. 1.165-1(d)(3), Income Tax Regs. In 1980, petitioners' state suit against Reed & Prince for damages for casualty and theft losses suffered was still pending. Therefore, in that year, petitioners still had a reasonable prospect of recovery which would compensate them for their losses. Dawn v. Commissioner, 675 F.2d 1077, 1078, (9th Cir. 1982); Estate of Scofield v. Commissioner, 266 F.2d 154, 159-160 (6th Cir. 1959). Consequently, petitioners are not entitled to the casualty and theft loss deductions raised during trial for the personal property which was the subject of the state court action and, as of the date of trial, the subject of the state court appeal.

On petitioners' 1980 return, they also claimed a deduction of $1,371 for personal property stolen from storage at Reed & Prince. This amount represented four tires and tubes, water skis, aluminum valve covers, two casement windows, a front door, and the desk, antique cupboard, and antique photograph removed from petitioner's office. We have already addressed, and sustained, respondent's disallowance of a loss deduction for the desk, antique cupboard, and photograph. The remaining items were

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missing when petitioner and his attorney sought to retrieve the property stored at Reed & Prince in 1980. They were not, however, included in petitioner's state suit against Reed & Prince.

To be deductible under section 165(a), "a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and * * *, actually sustained during the taxable year." Sec. 1.165-1(b), Income Tax Regs. As 1980 was the year the theft loss was discovered, it is the appropriate year for deduction of this item. Sec. 165(e); sec. 1.165-1(d)(3), Income Tax Regs. A theft loss deduction is limited to the lesser of the fair market value of the property or petitioner's adjusted basis in the property. See secs. 1.165-8(c) and 1.165-7(a)(1) and (b)(1), Income Tax Regs.; Ternovsky v. Commissioner, 66 T.C. 695, 697-698 (1976). In order to establish their entitlement to the claimed deduction, petitioners must prove not only the fact of loss, but the value of that loss. Burnet v. Houston, 283 U.S. 223 (1931); Roberts v. Commissioner, 62 T.C. 834, 835, 839 (1974); Elliott v. Commissioner, 40 T.C. 304, 311 (1963). On the attachment to petitioners' 1980 return they listed the following amounts as the cost bases of the items of personal property for which they claimed a deduction:

Four tires and tubes	$356[5]
Pair of water skis	$65
Aluminum valve covers	$50
Two casement windows and front door	$400

[5] Although this amount was increased to $388 in petitioners' Amended Petition, no explanation for the increase was given.

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The only evidence of the above asserted cost bases is petitioner's testimony. He could not recall the price he paid for the tires and tubes but looked up the cost of new tires in a magazine to arrive at the $356 figure. In valuing the pair of water skis, petitioner figured the cost of materials as he had made these skis. For the aluminum valve covers, petitioner testified that he remembered the cost of these covers when he bought them in 1952. Petitioner estimated the cost basis of the two casement windows at $300 and valued the front door, which had been beaten up during a house break-in at $100. Petitioner arrived at the cost basis for the windows and front door through conversations with his lawyer. In the absence of specific evidence, we will apply our best judgment to approximate the cost basis of these items, Cohan v. Commissioner, 39 F.2d 540 (2d Cir. 1930). We conclude that petitioners are entitled to a theft loss deduction of $200 for the used tires and tubes, $65 for the water skis, $50 for the aluminum valve covers and $300 for the casement windows and door, totaling $615.

Commencing in 1973, Reed & Prince implemented an Employee Profit-Sharing and Retirement Plan (Plan). This Plan provided that, in the event of termination, petitioner was entitled to receive all of the contributions which had been made by Reed & Prince to petitioner's employee account. The balance in said account as of December 31, 1980 was $20,248.79.[6] Under the terms

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6 An unspecified portion of this balance was earned due to investment of the company's contributions after petitioner's (footnote continued)

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of the Plan, upon his termination, petitioner should have received a payment of the lump sum in his account or provision for a fixed number of periodic payments or for a life annuity contract or a combination of these three methods of payment should have been instituted. At an unspecified date prior to trial, petitioner did, in fact, receive the amounts due him under the Plan.[7] Although he had received payment prior to trial, petitioner still sought an unspecified loss stating that "I feel that I should have equal treatment with other people who terminated at Reed & Prince and got their termination immediately." Petitioner's rationale for claiming a deduction in 1980 for lost use over a period of 7-1/2 years was that he "had to put it in sometime."

Petitioner asserts that he had lost 7-1/2 years of use of the money due him under the Plan. However, during this period amounts earned from investment of the principal in petitioner's account were credited to said account. Apparently he received, and his account was credited with, income from the "use" of funds in his account for each of the 7-1/2 years during which Reed & Prince held these funds. Consequently, he suffered no loss. Even if Reed & Prince had not so credited petitioner's account, he would

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(footnote continued from previous page)
employment terminated. For example, the balance as of December 31, 1979 was $18,735.08 and the amount of gain during the year from investment was $1,513.71 which amount was credited to petitioner's account.

7 Petitioner credited the IRS "helping him out" as the reason for his ability to finally obtain payment from Reed & Prince.

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not be entitled to a loss deduction. Deductions are a matter of legislative grace and taxpayers may not create deductions where none exist. New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934). The Internal Revenue Code does not provide a deduction for the "lost" use of money.[8] During trial petitioner also asserted he suffered a loss due to the failure of Reed & Prince to honor a 1969 "key management" agreement. The terms of this agreement provided that, upon termination, Reed & Prince was to pay petitioner $2,000 a month for 120 months commencing when he reached the age of 55.[9] The purported copy of this agreement received in evidence is signed by both petitioners. Although the document states that the corporate seal is affixed and that it is executed on Reed & Prince's behalf by Walter T. Nelson, neither the seal nor Nelson's signature appear on the exhibit. Nor were any minutes of the Board of Directors of Reed & Prince authorizing such an agreement offered in evidence and we question whether the agreement was ever bindingly executed. Petitioner never made any formal claim on Reed & Prince for payment under the agreement nor has he pursued any legal avenues for collection.[10] Petitioner's rationale for claiming a loss based on this agreement is that he received no payments under the agreement, realized that there was

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8 See, e.g., Crossland v. Commissioner, T.C. Memo. 1976-59, wherein a deduction for decline in the purchasing power of the dollar due to inflation was disallowed.

9 Petitioner was 55 years old on January 21, 1979.

10 Petitioner stated that he has not pursued possible legal remedies since he has been unable to find a lawyer who would handle the case.

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no further sense in trying to work with Reed & Prince to collect under the agreement, and "had to enter it somewhere." Even if the Agreement was enforceable, petitioner is not entitled to a deduction for Reed & Prince's failure to honor it. A deduction for the loss of anticipated income is not permitted. Hort v. Commissioner, 313 U.S. 28 (1941); Hutcheson v. Commissioner, 17 T.C. 14 (1951); Collin v. Commissioner, 1 B.T.A. 305 (1925). As to this agreement, petitioner's recourse, if any, is a suit against Reed & Prince, not the deduction he now claims.

In early 1980, petitioner was advised by an attorney with the Department of Justice that Reed & Prince was the subject of a grand jury investigation into possible antitrust violations. The investigation of Reed & Prince dealt with activities which occurred in 1963 and thereafter. Petitioner was not a target of the investigation. Based on instructions he received from an unidentified government lawyer, petitioner retained an attorney to advise him in connection with his appearance before the grand jury. This attorney performed various work for petitioner including review of documents, participation in numerous telephone conversations with petitioner and others, and attending informal interviews and conferences with government attorneys. The attorney submitted a bill for $1,211.20 for services rendered which petitioners paid during 1980.

Petitioners did not claim any deduction for legal fees on their 1980 return because petitioner erroneously believed he might be entitled to reimbursement for these expenses by Reed & Prince.

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However, he was not entitled to reimbursement. The deductibility of these attorney's fees under section 162(a) was initially raised during trial.

Section 162(a) allows a deduction for all ordinary and necessary expenses of carrying on a trade or business. Respondent challenges petitioners' deduction for attorney's fees paid approximately 3-1/2 years after petitioner was removed as president of Reed & Prince arguing that such fees were not "ordinary and necessary" to petitioner's business in 1980. We disagree. Petitioner's role as an officer and director of Reed & Prince from 1968 until mid-1976 constituted his trade or business in those years. Hochschild v. Commissioner, 161 F.2d 817 (1947); Steffens v. Commissioner, T.C. Memo. 1984-592. The grand jury investigation focused, in part, on events during those years and it is petitioner's activities during that period with which we must be concerned. Compare United States v. Gilmore, 372 U.S. 39 (1963) with Kornhauser v. United States, 276 U.S. 145 (1928).[11] Petitioner's involvement in the grand jury investigation, and the attorney's fees incurred and paid in connection therewith, were the proximate result of petitioner's business during the years he served as president and a director of Reed & Prince. To be deductible, this expense must also be ordinary and necessary to petitioner's business. Involvement in governmental investigations of the conduct of an industry, and/or the firms comprising an

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[11] See also Bellows v. Commissioner, T.C. Memo. 1967-199; Miller v. Commissioner, a Memorandum Opinion of this Court dated July 21, 1943.

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industry is, in many sectors, "normal, usual, or customary." While testifying before a grand jury was not a recurring activity for petitioner, it does not follow that expenses incurred therewith were not "ordinary" within the meaning of section 162(a). Welch v. Helvering, 290 U.S. 111 (1933); Salt v. Commissioner, 18 T.C. 182 (1952). We find petitioner's attorney's fees were an ordinary and necessary business expense. See also Commissioner v. Tellier, 383 U.S. 687 (1966). They are therefore, deductible in 1980, the year before the Court.

Decision will be entered under Rule 155.

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T. C. Memo. 1986-214

UNITED STATES TAX COURT

JAY CARTER AND JOAN H. CARTER, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 17951-83,
7071-84.

Filed May 28, 1986.

Held, because Ps failed to produce certain documents as ordered by this Court, R's motion for imposition of sanctions seeking dismissal of these cases under Rule 104(c), Tax Court Rules of Practice and Procedure, is granted.

Peter R. Stromer, for the petitioners.

M. Kendall Williams, for the respondent.

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MEMORANDUM OPINION

NIMS, Judge: These cases are before the Court on respondent's motion for imposition of sanctions pursuant to Rule 104(c).[1] Oral arguments on this motion were heard on November 13, 1985, at San Francisco, California.

In notices of deficiency mailed to petitioners bearing the dates of April 15, 1983, and March 2, 1984, respondent determined deficiencies in and additions to petitioners' Federal income tax as follows:

		Additions to Tax		
Year	Deficiency	Sec. 6653(a)(1)	Sec. 6653(a)(2)	Sec. 6661
1979	$7,704	$385	-	-
1980	7,604	380	-	-
1981	8,185	409	*	-
1982	5,721	286	**	$572

These deficiencies resulted from respondent's disallowance of the following deductions claimed by petitioners as charitable contributions to the Psychal Physionic Universal Life Church, a local congregation of the Universal Life Church of which petitioner Jay Carter was the "minister":

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[1] All rule references are to the Tax Court Rules of Practice and Procedure. Unless otherwise indicated, all section references are to sections of the Internal Revenue Code of 1954 in effect for the years in question.

* To be based on an underpayment of $8,185.

** To be based on an underpayment of $5,721.

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Year	Disallowed Deductions
1979	$20,200.00
1980	21,729.00
1981	22,873.20
1982	19,781.00

Respondent stated in the notices of deficiency that these deductions were disallowed because petitioners did not establish that (1) the amounts were to or for organizations which are qualified under section 170(c) of the Internal Revenue Code; (2) the Universal Life Church is an entity recognizable for tax purposes as separate and distinct from petitioners as individuals; and (3) petitioners did not receive from the Universal Life Church directly or indirectly money, goods, services or use of property in an amount equal to or exceeding the claimed deductions.

On July 5, 1983, and March 19, 1984, petitioners timely filed petitions with this Court contesting respondent's deficiency determinations and additions to tax, stating therein: (1) the charitable contributions were made to a local congregation of the Universal Life Church which was found to be a qualified charitable organization in Universal Life Church v. United States, 372 F. Supp. 770 (E.D. Cal. 1974); (2) they did not receive from the donee organization directly or indirectly any money, goods, services or use of the donated property; (3) the notice of deficiency was not timely mailed by respondent as

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to taxable year 1979; and (4) the Tax Court lacks jurisdiction to determine constitutional issues such as the validity of a church, its membership, doctrines, tenets and denominational status.

On July 23, 1985, respondent mailed to petitioners a set of interrogatories pursuant to Rule 71 and a request for production of documents pursuant to Rule 72 requesting certain information with respect to petitioners' Psychal Physionic Universal Life Church. Petitioners did not reply to the interrogatories nor produce the requested documents within the time provided by the Tax Court rules.[2]

On September 23, 1985, respondent filed a motion to compel responses to respondent's first set of interrogatories and to compel production of documents. By order dated October 1, 1985, we granted respondent's motion and ordered petitioners to answer each interrogatory and to produce the requested documents on or before October 21, 1985. This order was served on petitioners on October 3, 1985. Petitioners failed to answer respondent's interrogatories or to produce the requested documents by October 21, 1985, as ordered by this Court.

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[2] Rule 71 provides that "[t]he party, on whom the interrogatories have been served, shall serve a copy of his answers, and objections if any, upon the propounding party within 45 days after service of the interrogatories upon him." Under Rule 72, a party upon whom a request for production of documents has been served "shall serve a written response within 30 days after service of the request."

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On October 23, 1985, respondent filed a motion for imposition of sanctions pursuant to Rule 104(c) requesting that petitioners' cases be dismissed for failure to comply with this Court's order of October 1, 1985. We subsequently calendared respondent's motion for hearing at the Court's November 12, 1985, trial session at San Francisco, California.

Counsel for both parties appeared at the hearing. At the hearing, M. Kendall Williams, counsel for respondent, informed the Court that petitioners had responded to some of respondent's discovery requests subsequent to the filing of respondent's motion for imposition of sanctions. Mr. Williams stated, however, that petitioners did not produce any of the requested documents with respect to a bank account maintained in the name of the Psychal Physionic Universal Life Church at Foothill Bank, including bank statements, cancelled checks, deposit slips and signature cards. Mr. Williams explained the significance of these documents as follows:

> Well, the items -- the checks we are trying to get specifically were the checks which would show where the monies were from, the sources from Foothill Bank, which was the bank of the local congregation, the local charter. We need the information from that account to indicate where, in fact, the money went. In our opinion it did not go to ULC Modesto, but went back into Petitioners' hands. Without these documents we can just only question the Petitioners as far as their location, where the funds went. With these items, we feel as if we can make a definite circle as to where the monies went.

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At the motion hearing, we repeatedly requested Mr. Stromer, counsel for petitioners, to produce these documents. Following each request, however, Mr. Stromer represented to the Court that petitioners did not have possession or control of the bank documents and that neither he nor his clients knew who possessed the documents. We explained to Mr. Stromer tnat as sole signatories on the bank account, his clients would have received the bank documents in question. We therefore warned Mr. Stromer and petitioners that if they continued to disobey our order to produce the bank documents, we would dismiss the cases. Despite our warnings, Mr. Stromer and petitioners refused to produce the requested bank documents.

Rule 104 provides in pertinent part as follows:

> (c) Sanctions: If a party * * * fails to obey an order made by the Court with respect to the provisions of Rule 71, 72, * * * the Court may make such orders as to the failure as are just, and among others the following:
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> * * *
>
> (3) An order striking out pleadings or parts thereof, or staying further proceedings until the order is obeyed, or dismissing the case or any part thereof, or rendering a judgment by default against the disobedient party. [Emphasis supplied.]

Although dismissal is one of the most severe sanctions and should not be ordered indiscriminately, it is a proper sanction when failure to fully comply with this Court's discovery orders is due to willfulness, bad faith or other fault of the party. Dusha v. Commissioner, 82 T.C. 592, 604-605 (1984).

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In light of petitioners' willful failure to fully comply with our rules and a specific order of this Court, we think that dismissal of petitioners' cases is appropriate. At the motion hearing, we repeatedly explained to petitioners and their counsel that these documents were very relevant to the disposition of these cases and directed several times that they produce these documents. Despite our repeated directions, petitioners' counsel refused to produce the documents, stating that petitioners did not possess the documents and did not know who possessed them. We, however, simply do not believe the representations of petitioners' counsel that petitioners did not have custody and control of the requested bank documents given the fact that Mr. Carter was the founder and minister of the Psychal Physionic Universal Life Church and petitioners were the sole signatories on the bank account maintained in the name of the Psychal Physionic Universal Life Church at Foothill Bank.

Our rules of practice and our orders mean exactly what they say and we intend that they be complied with. Rosenfeld v. Commissioner, 82 T.C. 105, 111 (1984); Odend'hal v. Commissioner, 75 T.C. 400, 404 (1980); Branerton Corp. v. Commissioner, 61 T.C. 691, 692 (1974). Although given more than an ample opportunity to comply with our rules and an order of this Court, petitioners have not done so. On the record before us, we are satisfied that petitioners' failure to fully comply with discovery and a specific order of this Court was undertaken willfully and in bad

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faith. We therefore find that dismissal of these cases is appropriate. Accordingly, respondent's motion for imposition of sanctions will be granted, these cases will be dismissed and a judgment for default will be entered.[3]

To reflect the foregoing,

An appropriate order and decisions will be entered.

[3] We note that although petitioners alleged in their petition filed July 5, 1983, that the notice of deficiency was not timely mailed as to taxable year 1979, they did not raise the untimeliness of the deficiency notice as a defense to respondent's motion for imposition of sanctions nor did they present any evidence establishing that the notice of deficiency was not timely mailed. Thus, we find that respondent is not precluded from assessing the determined deficiencies and additions to tax as to petitioners' taxable year 1979.

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T. C. Memo. 1986-215

UNITED STATES TAX COURT

WILLIAM G. NORTH AND LOIS H. NORTH, Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 21147-80. Filed May 28, 1986.

William G. North, pro se.

Donald Rightnour, for the respondent.

MEMORANDUM OPINION

TANNENWALD, Judge: Respondent determined the following deficiencies and additions to petitioners' Federal income taxes:

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Taxable Year	Deficiency	Additions to tax Sec. 6653(a)[1]
1973	$ 19,282	$ 964
1974	98,705	4,935
1975	191,442	9,572
1976	6,753	338

The issues for decision are (1) whether payments made pursuant to certain agreements constituted income to petitioners or to a corporation known as Timber Management Far East Limited, and (2) whether petitioners are liable for additions to tax under section 6653(a).

This case was submitted fully stipulated under Rule 122. This reference incorporates herein the stipulations of facts and attached exhibits.

Petitioners, husband and wife, resided in Hamilton, New Zealand at the time they filed their petition in this case. They timely filed joint Federal income tax returns for the calendar years 1973 through 1976 with the Internal Revenue Service Center, Philadelphia, Pennsylvania. Petitioners were United States citizens during the taxable years at issue.

During the taxable years at issue, petitioner William G. North (hereinafter referred to as "petitioner") was in the business of providing services relative to the lumber industry, including consulting, management, quality control of log

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954, as amended and in effect during the years in issue, and all Rule references are to the Rules of Practice and Procedure of this Court.

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production, forest survey, road survey and road engineering. Petitioner entered into an agreement, effective January 1, 1973, with Seamech, Ltd. to provide such services in the Pagai Islands ("Timber Agreement"). The Timber Agreement provided that any necessary amendments or changes were to be made in writing and by mutual consent. The terms of the Timber Agreement were amended effective June 30, 1975 ("Amended Timber Agreement").

Seamech, Ltd. was part of a complex of corporations referred to herein as the Bowater Group, and various subsidiaries of the Bowater Group transacted business with petitioner, pursuant to the Timber Agreement and the Amended Timber Agreement (hereinafter sometimes collectively referred to as the "Timber Agreements"), including C.V. Minas Lumber Corporation, Gumer Ltd., Seamech Ltd., and Temenggong Securities Ltd. ("Temenggong").

On September 7, 1973, the Aeolus Trading Company Limited was incorporated in Hong Kong, and on October 9, 1973, the company changed its name to Timber Management Far East Limited ("TMFE"). Petitioner and his sons were the sole shareholders of TMFE.

On April 25, 1973, petitioner notified the Bowater Group (specifically Temenggong) that he was assigning the Timber Agreements to TMFE, and that he was acting solely as an agent for TMFE. Temenggong, however, refused to recognize the assignment and continued to treat the Timber Agreement (and in turn the Amended Timber Agreement) as a personal contract between

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petitioner and the Bowater Group. Throughout the taxable years at issue, the Bowater Group, in both its correspondence with petitioner and in its internal memoranda, never recognized TMFE as a party to the Timber Agreements.

During the taxable years at issue, the Bowater Group made payments for services performed under the Timber Agreements. Only one of these payments was made directly to TMFE, while the rest took the form of checks made out to "cash" which were personally endorsed by petitioner or one of his sons. Petitioner and members of his family also received numerous cash advances directly from the Bowater Group.

The central issue for decision is whether the payments made by the Bowater Group for services performed under the Timber Agreements constituted income to petitioner, individually, or to TMFE. Petitioner argues that he was merely an agent or employee of TMFE, and that all payments made by the Bowater Group to him were made for the account of TMFE and not to him personally. On this basis, petitioner claims that the only income he earned during each taxable year at issue was the salary he received from TMFE, which he claims never exceeded $25,000. Since petitioner was a United States citizen living abroad during these years, and since all the salary he allegedly received was foreign earned income not derived from sources within the United States, petitioner argues that he is entitled to the $25,000 exclusion on such income under section 911 during each of the taxable years at

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issue, and that he therefore owes no back taxes. Respondent, on the other hand, argues that the payments made by the Bowater Group were made not to TMFE, but to petitioner, personally, and that these payments thus constitute income earned by petitioner.[2] For the reasons discussed herein, we agree with respondent.

Resolution of this issue requires us to determine who in fact controlled the earning of the income, petitioner or TMFE. Bagley v. Commissioner, 85 T.C. 663, 675 (1985); Benningfield v. Commissioner, 81 T.C. 408, 418-419 (1983), and cases cited therein. Courts have examined two factors in making such a determination. First, it must be established that the service-performer is a person "whom the corporation has the right to direct or control in some meaningful sense." Johnson v. Commissioner, 78 T.C. 882, 891 (1982), affd. without published opinion 734 F.2d 20 (9th Cir. 1984); see also Vnuk v. Commissioner, 621 F.2d 1318, 1320-1321 (8th Cir. 1980), affg. a Memorandum Opinion of this Court; Bagley v. Commissioner, supra at 675; Schuster v. Commissioner, 84 T.C. 764, 776 (1985). Second, it must be shown that there exists "between the corporation and the person or entity using the services a contract or similar indicium recognizing the corporation's

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2 Respondent took the section 911 exclusion into account in making his determinations set forth in the deficiency notice.

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controlling position." Johnson v. Commissioner, supra at 891. See also Bagley v. Commissioner, supra at 675; Schuster v. Commissioner, supra at 775.

Petitioners have the burden of proving that respondent's determination was erroneous. Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a). After a careful review of the record, including the numerous exhibits, we find that petitioners have not met this burden.

Petitioners have failed to prove that petitioner was in fact subject to TMFE's control. They have offered no evidence, such as an employment contract or payroll records, that establish any such relationship between petitioner and TMFE. Moreover, they have failed to show that TMFE controlled or dictated petitioner's performance under the Timber Agreements. Concededly, there is a problem of proof in this respect where a closely-held or one-man personal service corporation is involved (see Bagley v. Commissioner, supra at 675), but the fact of the matter is that the record before us is devoid of any probative evidence as to how TMFE operated. The most that can be said, on the basis of that record, is that it was a nominee depositary of funds earned by petitioner.

With respect to the second criteria enunciated above, there is no evidence showing that there was a contract between TMFE and the Bowater Group, nor any action on behalf of the Bowater Group that would enable us to infer that such an agreement existed.

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Quite the opposite, not only did the Bowater Group refuse petitioner's request to revise the Timber Agreement and assign it to TMFE, but the overwhelming weight of the evidence indicates that throughout the years at issue the Bowater Group always treated the Timber Agreements as personal service contracts between it and petitioner, not TMFE. Petitioners' assertions on brief that there was an oral understanding on the part of the Bowater Group that the services were being performed on behalf of TMFE is simply without support in the record before us.

Some of the evidence of record does indicate that TMFE was a bona fide corporation engaged in providing timber related services. However, this is not the focus of the inquiry herein. For even assuming arguendo, that TMFE was a valid corporate entity for Federal income taxation purposes, petitioners have still failed to prove that the fees paid by the Bowater Group were earned by TMFE instead of petitioner. Moreover, petitioners, on brief, have tried to convince this Court that much of the objective evidence which argues against their position can be explained by looking at the regional peculiarities of doing business in Southeast Asia. However, petitioners were clearly forewarned that they could not testify by brief in order to meet their burden of proof. Nevertheless, petitioners opted to litigate their case by mail from New Zealand, and have offered us no testimony, from either themselves or from other witnesses, that is admissible as evidence to

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corrobrate the claims they have asserted. Thus, absent the introduction of such additional evidence, petitioner's arguments and explanations cannot be taken into account in reaching our decision herein.[3]

Finally, we turn to whether petitioners are liable for additions to tax under section 6653(a) for "negligence or intentional disregard of rules and regulations." Once again, the burden of proof is on petitioners, Tomburello v. Commissioner, 86 T.C.___ (March 31, 1986)(slip opinion at 11); Rule 142(a), and again we find that petitioners have failed to meet their burden. Given the Bowater Group's refusal to accept petitioner's assignment and revision of the Timber Agreement, coupled with their consistent treatment during the taxable years at issue of the Timber Agreements as personal service contracts with petitioner, we find to be unrealistic any claim by petitioner that he in good faith believed that TMFE was the true earner of the income. Compare Wofford v. Commissioner, 5 T.C. 1152, 1166 (1945). The assertions on brief of an oral understanding by the Bowater Group are of no help to petitioners on the issue of good faith because of the absence of probative evidence in the record.

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3 Petitioners make vague claims to deductible expenses if the income in question is charged to them. However, respondent allowed various expenses as offsets to the claimed income during the years at issue and there is no probative evidence of record to support an allowance of additional amounts.

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In essence, petitioners ask us to fill in the gaps in the record by drawing inferences favorable to them. The problem is that the facts of record are too few and the gaps too large for us to accede to their request.

Decision will be entered for the respondent.

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T. C. Memo. 1986-216

UNITED STATES TAX COURT

JOHN M. SEELY and BARBARA J. SEELY, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 22230-83. Filed May 29, 1986.

Debra L. Bowen, for the petitioners.

Paul H. Weisman, for the respondent.

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MEMORANDUM FINDINGS OF FACT AND OPINION

COHEN, Judge: Respondent determined the following deficiencies in petitioners' Federal income taxes:

Year	Deficiency
1976	$ 778
1977	12,871
1978	8,900
1979	11,729

The issues for decision are (1) whether petitioners' corporation executed a valid subchapter S election for the years in issue; (2) whether petitioners are entitled to an investment tax credit and depreciation and other expense deductions regarding their master recording activity; and (3) whether petitioners are liable for additional interest under section 6621(d).[1]

FINDINGS OF FACT

Some of the facts have been stipulated. The stipulation of facts and attached exhibits are incorporated herein by this reference.

Petitioners John M. Seely (petitioner or John M. Seely) and Barbara J. Seely resided in Manhattan Beach, California, at the time their petition was filed. They filed joint Federal income tax returns for each of the years in issue.

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1 Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1954, as amended and in effect during the years in issue.

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Petitioner was employed by the Los Angeles City College as a physical education and health instructor, and petitioner's wife was employed by an elementary school to teach a variety of subjects. They reported on their tax returns combined wages of $45,898, $53,276, $52,097, and $58,189 for years 1976, 1977, 1978, and 1979, respectively.

In 1976, petitioners and two other individuals, Clarke and Pritko, purchased Harbor Village Inn, a restaurant and cocktail lounge. They initially operated the business as a general partnership, and petitioners' interest in the partnership was held in the name John M. Seely. The form of ownership was changed to a corporation entitled Clarke, Pritko, and Seely, Inc. (the corporation) in or about November 1976. A Form 2553 (Election by Small Business Corporation) was executed on December 4, 1976, by petitioner, who was Treasurer of the corporation, and subsequently submitted to the Internal Revenue Service Center in Fresno, California. That form provided that the corporation was incorporated on November 1, 1976, and commenced business on November 14, 1976. It identified the following shareholders and their respective shares: Clarke, 1,350 shares; Pritko, 1,350 shares; and John M. Seely, 2,700 shares. The form further provided as follows: "For this election to be valid, the consent of each stockholder must accompany this form or be shown below. See instruction D." Instruction D, on the reverse side of the form, included the following requirement: "[t]he consent must be signed by both

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husband and wife if they have a community interest in the stock or the income from it, and by each tenant in common, each joint tenant, and each tenant by the entirety." Under the heading "Shareholders' statement of consent," John M. Seely signed and dated the form on December 5, 1976, and Clarke and Pritko signed and dated the form on December 8, 1976. Barbara J. Seely did not sign the form. The shares in John M. Seely's name were held as community property by petitioners.

In or about 1977, petitioner met by happenstance Paul Hendison (Hendison), a sales representative for Jackie Resources, Inc., a corporation which offered master recordings for sale. Hendison explained to petitioner about his business and about master recordings. Petitioner then listened to a number of recordings and particularly liked one by Johnny Dark entitled "Avocado Summer." Approximately one week later, petitioner returned to Jackie Resources with his wife. She listened to "Avocado Summer" and also liked it.

Petitioners, who had no prior experience with master recordings, were provided a document dated October 17, 1977, and entitled "Jackie Resources, Inc. Presents Information Memorandum Relating to Purchase of a Master Recording" (memorandum). The memorandum contained information regarding the following: product - a master recording, purchase price, distribution, and tax considerations. The memorandum stated that the records to be sold commercially might be distributed by the purchaser or a distributor selected by the purchaser. A list of prospective

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distributors, including International Record Distributing Associates, was attached to the memorandum. The memorandum noted that if a distributor is used, a portion of the initial distribution expenses may be borne by the purchaser.

The memorandum stated that the profit potential for any record was "extremely speculative" and that a record rarely generated enough receipts to pay the full purchase price or produce any profits. The memorandum emphasized tax considerations such as depreciation and investment tax credit. For example, based on a hypothetical purchase price of $137,500 ($12,500 cash at closing, a $12,500 promissory note due the subsequent year at 8 percent interest and secured by a letter of credit, and a $112,500 nonrecourse promissory note due in 8 years at 6 percent interest), an income forecast method of depreciation (7 years useful life), and an assumed individual income tax bracket of 50 percent, the memorandum set forth the following information in a table identified as "Master Record Purchase Tax Write-Off Illustration":

	Cash Outlay				Deductions		
Year	Down-payment	Distribution Cost	Total	Depreciation Percentage	Depreciation	Distribution Cost	Total
1	$12,500	$2,700	$15,200	40%	$ 55,000	$2,700	$ 57,700
2	12,500	-0-	12,500	50%	68,750	-0-	68,750
3-7	-0-	-0-	-0-	10%	13,750	-0-	13,750
TOTAL	$25,000	$2,700	$27,700	100%	$137,500	$2,700	$140,200

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	Tax			Equivalent Write-Off	
Year	Tax Savings On Deductions	Investment Tax Credit	Total	Dollars	Multiple
1	$28,850	$9,167	$38,017	$ 76,034	5.0
2	34,375	-0-	34,375	68,750	5.5
3-7	6,875	-0-	6,875	13,750	___
TOTAL	$70,100	$9,167	$79,267	$158,534	5.7

More than 45 percent of the text of the memorandum was devoted to "tax risks" and "income tax factors." It repeatedly recognized the potential for challenge by the Internal Revenue Service, particularly with regard to basis, at-risk rules, and section 183.

The memorandum stated that the seller would provide the purchaser with two "appraisals" of the master recording and recommended that the purchaser obtain an independent appraisal. Petitioners were given two letters addressed to Jackie Resources, Inc. and dated March 1977. One letter, from Ernie Freeman of Hollywood, California, stated that "Avocado Summer" was "well produced and conceived in recording," that it should realize sales of up to 250,000 units, and that $110,000 seemed to be a fair price for the master recording. The other letter, from Douglas L. A. Foxworthy of La Jolla, California, stated that "Avocado Summer" was an "excellent instrumental country vocal easy listening master" and that sales should exceed 350,000 units. Petitioners did not seek any other appraisal; however, Hendison estimated to petitioners that they would sell 100,000 copies during the first year.

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On December 20, 1977, petitioners executed an agreement to purchase the master recording for "Avocado Summer." The purchase price was $110,000, comprised of a $20,000 cash downpayment and a nonrecourse promissory note for $90,000 due May 31, 1985, and payable solely out of proceeds from record sales. A security agreement and an assignment of sales proceeds on the $90,000 note were also executed by the parties. Under the assignment of sales proceeds, petitioner agreed to pay to Jackie Resources $.75 for each album sold ($.25 if the selling price of album was under $3.95) and $.10 for each single record sold until the note was paid in full. Petitioners paid the cash portion of the purchase price by two cashiers checks dated December 22 and 29, 1977.

At some time in 1977 or 1978, petitioners received literature on International Record Distributing Associates (IRDA), an association of small independent record companies headquartered in Nashville, Tennessee. Subsequent to a conversation with the president of IRDA, petitioners received the following letter:

> November 20, 1978
>
> Dear Mr. Seely:
>
> As per our conversation today, please find enclosed two executed copies of our Employment Contract. Please sign both, retaining one for your files and return the other to me with your check for $2,250.00.
>
> We shall obtain the master tape and label copy from Jackie Resources and your album "AVOCADO SUMMER" by Johnny Dark will go into production as soon as we receive all the materials.

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Also, please find enclosed our company's press kit which will give you more information about IRDA.

We are very happy to be working with you on this project and if there is anything else you require, please let me know.

Very truly yours,

/s/ Hank Levine

Hank Levine
President
IRDA/ALBUM WORLD

The employment contract referenced in the letter quoted above was dated November 20, 1977, and provided for the distribution of "Avocado Summer" by IRDA. In the employment contract, petitioner represented that he owned all rights, title, and interest in and to the master recording of "Avocado Summer" by Johnny Dark. Petitioner agreed to pay IRDA $2,250 to produce 1,000 records and to exploit, advertise, and promote the records. For each album sold and not returned, IRDA agreed to pay petitioner $1.69, and for each single record sold and not returned, IRDA agreed to pay petitioner $.20. The contract required IRDA to submit to petitioner periodic statements every 180 days and granted petitioner the right to terminate the contract by giving IRDA 10 days' written notice.

Petitioners made several phone calls to IRDA regarding the progress of production and distribution of "Avocado Summer." In response, petitioner received a letter from IRDA on March 19, 1979, stating that it would soon be ready to go into full distribution of "Avocado Summer" and that the albums might reach

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the market place in 4 to 6 weeks. On April 11, 1979, petitioner received another letter from IRDA. That letter stated that the primary cause for delay in distribution was approval of the album cover and test pressing and that the album would be a big commercial success because of Johnny Dark's recent television exposure on "Make Me Laugh."

Petitioners received copies of the album "Avocado Summer." They played the album in their lounge and also handed out promotional copies. Petitioners telephoned several radio stations to verify that the stations had received "Avocado Summer" and that the album was being promoted by IRDA. Although stations contacted had received the album, petitioners learned that IRDA had conducted no promotional campaigns. Petitioners did not receive the periodic statements promised by IRDA except for two royalty statements, one of which was marked "final statement." These statements reflect three transaction dates: December 30, 1980; June 30, 1981; and December 30, 1981. On these dates, the statements report some or all of the following: zero consignments sales in units, zero net units sold or unreturned, zero units paid or previously reported and paid, and zero dollars due. Petitioners maintained no business records or bank accounts regarding the master recording.

Subsequent to petitioners' taxable years in issue, Johnny Dark's success as a performer grew. He performed in Las Vegas, Nevada, at the Hacienda Resort Hotel and Casino in 1981 and at the MGM Grand Hotel in 1984.

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On their Federal income tax returns for each of the years in issue, petitioners deducted 50 percent of the corporation's losses. On their 1976 tax return, petitioners computed their share of the corporation's investment tax credit; however, the credit did not reduce their tax liability because they reported no tax due. On their 1977 tax return, petitioners deducted from their tax liability an investment tax credit for their purchase of the master recording. On their 1977, 1978, and 1979 tax returns, petitioners deducted losses arising from their master recording activity; these losses were composed of depreciation expenses, a distribution fee, and other nominal expenses.

In his notice of deficiency, respondent disallowed petitioners' share of the corporation's loss deductions and petitioners' share of the corporation's investment tax credit on the ground that petitioners' corporation did not execute a valid election for subchapter S status. Respondent disallowed the losses arising from petitioners' master recording activity on the grounds that the purchase of the master recording was a sham and that the activities associated with the master recording did not constitute trade or business activities under section 162 or income producing activities under section 212. Respondent also disallowed the 1977 investment tax credit on the ground that the master recording did not qualify for the investment tax credit. Before the trial of this case, respondent amended his answer to

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assert that petitioners are liable for additional interest under section 6621(d).

OPINION

Subchapter S Issue

Section 1372(a) provides that any small business corporation may elect not to be subject to taxation under chapter 1 of the Internal Revenue Code and that "such election shall be valid if all persons who are shareholders in such corporation * * * consent to such election." Section 1372(c) provides that the election shall be made in such manner as the Secretary shall prescribe by regulations. Section 1.1372-3(a), Income Tax Regs., provides in pertinent part as follows:

> The consent of a shareholder to an election by a small business corporation shall be in the form of a statement signed by the shareholder in which such shareholder consents to the election of the corporation. * * * Each person who is a shareholder of the electing corporation must consent to the election; thus, where stock of the corporation is owned by a husband and wife as community property (or the income from which is community property), or is owned by tenants in common, joint tenants, or tenants by the entirety, each person having a community interest in such stock and each tenant in common, joint tenant, and tenant by the entirety must consent to the election. * * *

Respondent determined that petitioners' corporation's subchapter S election was invalid because petitioner's wife, Barbara J. Seely, did not sign the election form.

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Petitioners argue that although they held the corporate stock as community property, petitioner John M. Seely's signature is sufficient for a valid election because the signature of both spouses is not required by California community property law regarding personal property. We disagree. Federal tax statutes are not to be limited by State laws that identify and describe the relationship between individuals and other potential taxpayers. Commissioner v. Tower, 327 U.S. 280, 288 (1946); Burnet v. Harmel, 287 U.S. 103, 110 (1932).

Petitioners also argue that respondent is estopped from denying the election because the language on respondent's Form 2553 did not, during the years in issue, require the consent of both spouses holding the stock as community property. In support of this argument, petitioners cite Allied Steel Construction Co. v. Employers Casualty Co., 422 F.2d 1369, 1371 (10th Cir. 1970), for the proposition that "estoppel arises where one party makes by its words or actions a false representation of fact, and the other party reasonably relies on the misrepresentation and is prejudiced thereby." Petitioners contend that estoppel applies because the 1976 Form 2553 failed to require on its face the consent of petitioner's wife and because subsequent Forms 2553 promulgated by the Internal Revenue Service have included this requirement on the face of the document.

Although the face of the 1976 form did not set out the consent requirement, the instructions on the back of the form did. Petitioners argue that because the form was subsequently

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revised, respondent has admitted that the 1976 form was misleading. This argument lacks merit. The fact that the form could be improved does not mean that it was misleading or that the instructions, or the applicable law, could be ignored. Neither respondent nor any agent of respondent made any misrepresentation regarding the consent requirement for a valid subchapter S election. These circumstances do not give rise to an estoppel.

Cases applying section 1372 to stock held as community property have consistently denied subchapter S status to corporations where the election form failed to include the spouse's consent, Clemens v. Commissioner, 453 F.2d 869 (9th Cir. 1971), affg. a Memorandum Opinion of this Court, and where the spouse's written consent was untimely, Forrester v. Commissioner, 49 T.C. 499 (1968). Petitioners argue that Forrester, on which the court in Clemens exclusively relied, can be distinguished factually. Petitioners contend that in Forrester, the wife (of a record shareholder) filed a separate untimely consent and that therefore the husband was not purporting to act for the community. Here, petitioner's wife, according to testimony, orally consented to whatever action petitioner might take; therefore, petitioner argues that he was acting for the community.

Petitioners' reliance, however, on the "acting for the community" dictum of Forrester ignores our application therein of a hard and fast rule which requires a spouse's filed consent and

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which has been consistently and strictly applied since about 1960. As we stated in Forrester in our analysis of the relevant statutes, regulations, and particularly the legislative history, Congress consented to and approved the Commissioner's requirement that both spouses must make the election in community property states. See Forrester v. Commissioner, 49 T.C. at 506-507. Cf. Wilson v. Commissioner, 560 F.2d 687 (5th Cir. 1977) (where an election was upheld without a record shareholder's wife's consent; because the record shareholder held only a nominal interest in the corporation, he did not have a "beneficial ownership" and therefore did not meet the definition of a shareholder for purposes of the consent requirement).

Although we are not unsympathetic to petitioners' position on this issue, they have not brought themselves within any exception to the controlling authorities. Petitioners' deductions of the corporate losses and the corporate investment tax credit were therefore properly disallowed by respondent.

Master Recording

Petitioners argue that the purchase of the master recording was a valid business transaction entered into with a bona fide objective of making a profit and that therefore they are entitled to depreciation and other expense deductions and an investment tax credit based on their $20,000 cash investment in the master recording. Because petitioners are now asserting entitlement only with regard to the $20,000 cash paid, we recognize this as a

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concession that they are not entitled to any deductions or an investment tax credit with respect to the the $90,000 nonrecourse note.

Respondent argues that the master recording activity was not engaged in for profit and that the purchase of the master recording was a sham transaction. Respondent further argues that the property does not qualify for investment tax credit. If we find that the purchase of the master recording was not a sham transaction but that the activity was engaged in for profit, respondent argues that petitioners' basis in the master recording cannot include any excess of the purchase price over the fair market value of the master recording. According to respondent (and the only evidence of fair market value), that is $10,000.

To qualify for the claimed depreciation and other expense deductions with respect to the master recording, petitioners must demonstrate that the master recording was used in a trade or business or was held for the production of income. Sections 162, 167, and 212. Under section 48(a)(1), the investment tax credit is allowable only for property for which depreciation (or amortization in lieu thereof) is allowable. Thus, petitioners' right to the deductions and investment credit depends on their showing that the activity in question constituted a trade or business or was undertaken and carried on for the production of income. See Beck v. Commissioner, 85 T.C. 557, 569 (1985).

Essential to such a showing is a demonstration that petitioners had "an actual and honest objective of making a

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profit." Beck v. Commissioner, supra; Estate of Baron v. Commissioner, 83 T.C. 542, 553 (1984), on appeal (2d Cir., Mar. 26, 1985); Dreicer v. Commissioner, 78 T.C. 642, 646 (1982), affd. without opinion 702 F.2d 1205 (D.C. Cir. 1983). A reasonable expectation of making a profit is not required; however, petitioners' objective of making a profit must be bona fide. Beck v. Commissioner, supra; Estate of Baron v. Commissioner, supra; Fox v. Commissioner, 80 T.C. 972, 1006 (1983), affd. without published opinion 742 F.2d 1441 (2d Cir. 1984), affd. sub nom. Barnard v. Commissioner, 731 F.2d 230 (4th Cir. 1984), affd. without published opinion sub nom. Zemel v. Commissioner, 734 F.2d 9 (3d Cir. 1984), affd. without published opinion sub nom. Rosenblatt v. Commissioner, 734 F.2d 7 (3d Cir. 1984), affd. without published opinion sub nom. Krasta v. Commissioner, 734 F.2d 6 (3d Cir. 1984), affd. without published opinion sub nom. Leffel v. Commissioner, 734 F.2d 6 (3d Cir. 1984), affd. without published opinion sub nom. Hook v. Commissioner, 734 F.2d 5 (3d Cir. 1984). Courts often use words such as "basic," "dominant," "primary," "predominant," and "substantial" to describe the requisite profit objective. Beck v. Commissioner, 85 T.C. at 570, and cases cited therein. In this context, "profit" means economic profit, independent of tax savings. Beck v. Commissioner, supra, and cases cited therein. If the activity is not engaged in for profit, the deduction of petitioners' expenses relating to the activity is allowed only to

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the extent of gross income generated by the activity. Section 183(a) and (b).

Whether petitioners possessed the requisite profit motive is a question of fact to be determined on the basis of all the facts and circumstances.[2] Beck v. Commissioner, 85 T.C. at 570; Estate of Baron v. Commissioner, supra. No one factor is determinative; however, greater weight will be given to objective facts than to petitioners' statements of intent. Beck v. Commissioner, supra; section 1.183-2, Income Tax Regs. The burden of proof is on petitioners. Welch v. Helvering, 290 U.S. 111 (1933); Surloff v. Commissioner, 81 T.C. 210, 233 (1983); Rule 142(a), Tax Court Rules of Practice and Procedure.

Based on our consideration of all the facts and circumstances, we conclude that petitioners did not engage in

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2 Section 1.183-2(b), Income Tax Regs., lists some of the factors to be considered in determining whether an activity is engaged in for profit. The factors listed in the regulations are as follows:

> (1) Manner in which the taxpayer carries on the activity. * * *
> (2) The expertise of the taxpayer or his advisors. * * *
> (3) The time and effort expended by the taxpayer in carrying on the activity. * * *
> (4) Expectation that assets used in activity may appreciate in value. * * *
> (5) The success of the taxpayer in carrying on other similar or dissimilar activities. * * *
> (6) The taxpayer's history of income or losses with respect to the activity. * * *
> (7) The amount of occasional profits, if any, which are earned. * * *
> (8) The financial status of the taxpayer. * * *
> (9) Elements of personal pleasure or recreation. * * *

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their master recording activity with an actual and honest objective of making a profit. Therefore, because no income was generated by the activity, petitioners are not entitled to any deductions or an investment tax credit regarding the master recording activity.

Petitioners testified that they purchased the master recording hoping to make a lot of money so they could buy their "dream house." Even assuming we accept this testimony, it does not mean that petitioners had an "actual and honest objective of making a profit" when they purchased the master recording. Increased spendable income resulting from increased deductions may have satisfied the objective they described.[3]

Petitioners' conduct prior to their purchase of the master recording of "Avocado Summer" did not indicate a profit objective. Petitioners argue that their decision to purchase the master recording was based on the following: (1) petitioners met a record promoter; (2) petitioners listened to a recording of "Avocado Summer" and liked it; (3) petitioners read two "appraisal" letters provided by the seller which favorably described the profit potential of "Avocado Summer"; and (4) petitioner allegedly calculated a profit of $50,000 to $60,000 on the sale of 100,000 albums. Petitioners, however, did not have any experience in the distribution of master recordings. They did not consult any independent experts regarding the

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3 See Holland v. Commissioner, T.C. Memo. 1985-626, slip opinion at page 17.

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distribution of master recordings or specifically regarding the profit potential of the master recording of "Avocado Summer." Petitioners' information memorandum on the purchase of master recordings repeatedly warned that profit potential was extremely speculative and that a record rarely generated enough receipts to pay for the purchase price. Furthermore, if petitioners had seriously considered the nontax merits of the investment, it is improbable that they would have blindly relied on appraisals furnished by the seller, particularly in view of the cautionary language in the information memorandum. See Beck v. Commissioner, 85 T.C. at 572.

Petitioner testified as follows regarding his alleged profit calculation:

> My profit margin was roughly a $1.70 per album and at that rate, 100,000 albums would have been about $170,000. I would have owed $110,000, so I figured about a $50,000 or $60,000 profit. * * *

Petitioner provided no details or documents to explain or support his alleged computation. It is incomplete and unrealistic. Petitioner ignored the interest to be paid on the $90,000 debt obligation and failed to take into account the costs of production and distribution. Those costs were $2,250 for the first 1,000 albums, or $2.25 per album, which is 56 cents more than the $1.69 per album actually sold that petitioner would have earned under the agreement with IRDA had any of the 1,000 albums been sold. Because petitioner made no arrangements for

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production of additional albums, we do not know what those costs would have been. But apparently neither did petitioner.

Petitioner testified that he knew nothing about the potential tax consequences resulting from the purchase of a master recording. This testimony is difficult to believe, especially in view of the information memorandum. More than 45 percent of the text of that memorandum was devoted to the tax ramifications of purchasing a master recording. Also, petitioner testified that he did not see the information memorandum until after the decision had been made to purchase the master recording of "Avocado Summer." If this is true, it supports the conclusion that petitioners did not have an actual and honest profit objective, particularly in view of their lack of experience in the distribution of master recordings. Petitioner may not have understood the tax concepts discussed in the memorandum, but we cannot believe that he ignored the "bottom line" calculations.

Petitioner testified that he negotiated the terms of the purchase agreement. He gives no details, however, as to these negotiations. Also, the purchase agreement appears to be a standard form agreement prepared by or for Jackie Resources, Inc., to which names, dates, signatures, and other relevant data are added in the blanks.

Petitioners' conduct after their purchase of the master recording also fails to indicate a profit objective. Petitioners did not maintain separate bank accounts or separate business records for their master recording activity. See Beck v.

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Commissioner, 85 T.C. at 576-577. Petitioners' distributor, IRDA, did not distribute any records and did not provide petitioners the periodic statements as required by the employment contract. Nevertheless, petitioners did not change distributors although they could have done so with 10 days' prior written notice. Petitioners testified that they made several phone calls to IRDA in monitoring the distribution of the albums; that they also phoned several radio stations to see if the radio stations had received copies of the album; and that they played the album in their lounge and gave out promotional copies to patrons of their lounge. Petitioners, however, never made arrangements to manufacture more than 1,000 records, although the projections on which the seller's appraisals were based assumed sales of 250,000 or 300,000 albums, and petitioners' own profit calculations assumed sales of 100,000 albums.

Petitioners' use of a large nonrecourse note indicates the lack of an actual and honest objective of making a profit because the note was contingent, illusory, and without any real economic substance. Even the information memorandum specifically stated that a record rarely generated enough receipts to pay the full purchase price. On numerous occasions, we have stated that "the existence of large nonrecourse notes in circumstances where it is unlikely that the notes will be paid is itself an indication that the primary objective of an activity is to generate tax deductions rather than to earn an economic profit." Seaman v.

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Commissioner, 84 T.C. 564, 596 (1985). See Estate of Baron v. Commissioner, 83 T.C. at 556.

The lack of order and chronology of transaction dates as reported on various documents and as testified to by petitioners also shows an absence of businesslike conduct. Of particular importance is a letter from Jackie Resources dated November 20, 1978. That letter stated (1) that petitioners should sign the enclosed "employment contract" and return it with the required payment of $2,250; (2) that when IRDA received the master recording and other necessary materials from Jackie Resources, the album would soon go into production; and (3) that its enclosed press kit would provide more information on IRDA. This letter suggests that the employment contract with IRDA had not, at that time, been executed by both parties and that IRDA had not, at that time, received a master recording from Jackie Resources. Petitioner testified, however, that he received his own copies of the album (which must be made from the master recording) from IRDA in the spring of 1978, more than 6 months before the date of this letter. The employment contract is dated November 20, 1977, a year before the date of the letter and before petitioner was asked to sign the employment contract enclosed in the letter. Petitioners claimed depreciation deductions and an investment tax credit in 1977 regarding the master recording activity although, according to this letter, the album was not even in production as of November 20, 1978. Furthermore, petitioner, in the employment contract, confirmed

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his title to and ownership of the master recording; however, petitioner did not even purchase the master recording until one month after the date of the employment contract. Based on these inconsistencies, we find it difficult to accept petitioner's uncorroborated testimony and petitioners' assertions that they had an actual and honest objective of making a profit.

Respondent analogizes the facts in this case to those in Estate of Baron v. Commissioner, supra, wherein we denied a taxpayer's claimed deductions regarding a master recording activity. In Baron, the taxpayer purchased a master recording for $650,000, comprised of $90,000 cash and nonrecourse notes for $560,000 payable solely out of the record sales proceeds. The master recording was a sound track to the movie "The Deep"; it had a famous artist, Donna Summer, and a well-known distributor, Casablanca. Nevertheless, because of Baron's lack of experience in the area, Baron's lack of investigative efforts, the extensive amount of the nonrecourse notes, and Baron's failure to check production and distribution progress, we held that no profit objective existed.

Petitioners argue that Estate of Baron is distinguishable from this case because (1) petitioners, unlike the taxpayers in Estate of Baron, were not actively seeking investments; (2) the purchase price and the nonrecourse financing were much larger in Estate of Baron; (3) the taxpayers in Estate of Baron were in a higher tax bracket than petitioners; (4) no appraisals were available before the purchase of the master recording in Estate

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of Baron; and (5) petitioners took a more active role in the master recording activity than the taxpayers in Estate of Baron. Mindful of those assertions, we nevertheless conclude that the determinative factors are the same in both cases, i.e., (1) lack of prior experience in the area, (2) very little prepurchase investigation of the activity, (3) a large nonrecourse note payable solely out of sales proceeds, and (4) very little monitoring of production and distribution of the record.[4] The applicable rules do not vary based on the particular tax bracket or the dollar amounts involved. Also, petitioners' conduct, while arguably more active than the conduct of the taxpayers in Estate of Baron, was only minimal. Having made a few telephone calls, having played the album and given away promotional copies, and having read an "appraisal" before the purchase of the master recording do not carry petitioners' burden of proving a profit objective. Cf. Independent Electric Supply, Inc. v. Commissioner, 781 F.2d 724 (1986), affg. a Memorandum Opinion of this Court.

Petitioners have, on brief, apparently conceded the issue with respect to the nonrecourse note; however, that concession does not affect our analysis of petitioners' intent at the time they entered into and conducted the master recording activity. As in Estate of Baron, the most reasonable conclusion is that the anticipated tax benefits resulting from the inclusion of the

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[4] See also Watts v. Commissioner, T.C. Memo. 1985-531; Snyder v. Commissioner, T.C. Memo. 1985-9.

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nonrecourse note in the purchase price were the primary incentive for petitioners' involvement in the master recording activity.

Where an asset is purchased using nonrecourse indebtedness, whether the fair market value of the asset approximated its purchase price may be considered in determining whether the taxpayer possessed the necessary profit objective. Beck v. Commissioner, 85 T.C. at 577, and cases cited therein. Respondent offered the only expert witness at trial and also produced a report prepared by the expert witness summarizing his examination of the album and the relevant documents associated with petitioners' master recording activity. Petitioners' cross-examination failed to impeach respondent's witness, and his testimony and report were not contradicted by other evidence. (Although petitioners argue that they relied on the appraisals provided by the seller, those appraisals are hearsay and can only be considered in relation to petitioner's intent and not as evidence of value.) In his report, respondent's witness stated that in his opinion the master recording of "Avocado Summer" was worth approximately $10,000. This value of the master recording was substantially less than the purchase price of $110,000 on which petitioners based their deductions and credits during the years in issue.

In conclusion, we hold that petitioners failed to satisfy their burden of proving that they engaged in the master recording activity with an actual and honest objective of making a profit. As a result, we need not address respondent's alternative

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arguments that the purchase of the master recording was a sham transaction, that the property was not eligible for the investment tax credit, and that petitioners' basis in the master recording cannot include any excess of the purchase price over the fair market value of the master recording.

Additional Interest

By Amendment to the Answer, respondent asserted the applicability of section 6621(d), dealing with interest on substantial underpayments attributable to tax motivated transactions. Because respondent has raised a "new matter," he bears the burden of proof on that issue. Rule 142(a), Tax Court Rules of Practice and Procedure.

Section 6621(d) provides for an interest rate of 120 percent of the adjusted rate established under section 6621(b) where there is a "substantial underpayment" (an underpayment of at least $1,000) in any taxable year "attributable to 1 or more tax motivated transactions." This section applies only with respect to interest accruing after December 31, 1984, even though the transaction was entered into prior to the date of enactment of section 6621(d). Solowiejczyk v. Commissioner, 85 T.C. 552 (1985), on appeal (2d Cir., Mar. 24, 1986).

Section 6621(d)(3) includes within the definition of tax motivated transactions (1) any valuation overstatement (within the meaning of section 6659(c)) and (2) any loss disallowed by reason of section 465(a). Section 6621(d)(3)(B) permits the

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Secretary of the Treasury to prescribe by regulation other types of transactions that constitute tax motivated transactions. Section 301.6621-2T, Q and A-4, Proced. & Admin. Regs. (Temporary), includes within the definition of tax motivated transactions any deductions disallowed for any period under section 183, relating to an activity engaged in by an individual that is not engaged in for profit.

Section 301.6621-2T, Q and A-5, Proced. & Admin. Regs. (Temporary), provides the following method by which the amount of an underpayment of tax attributable to one or more tax motivated transactions is determined:

> (1) Calculate the amount of the tax liability for the taxable year as if all items of income, gain, loss, deduction, or credit, had been reported properly on the income tax return of the taxpayer ("total tax liability"); and
>
> (2) Without taking into account any adjustments to items of income, gain, loss, deduction, or credit that are attributable to tax motivated transactions (as defined in A-2 through A-4 of this section), calculate the amount of the tax liability for the taxable year as if all other items of income, gain, loss, deduction, or credit had been reported properly on the income tax return of the taxpayer ("tax liability without regard to tax motivated transactions").
>
> (3) The difference between the total tax liability and the tax liability without regard to tax motivated transactions is the amount of tax motivated underpayment.

At the conclusion of trial, the Court directed respondent to comment in his brief as to the appropriate means of calculating the amount of the underpayment "attributable to" tax motivated

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transactions referred to in section 6621(d). Petitioners were told that they would have to deal with respondent's approach. Alternative calculations apply because of the separate issues in this case, i.e., the claimed subchapter S losses and the master recording items, as well as the alternative grounds for disallowance of the master recording deductions and credits. See Law v. Commissioner, 84 T.C. 985, 993 (1985). Respondent carefully laid out in his brief his contentions and computations on each alternative basis for our decision.

Respondent's primary position is that the deductions and investment tax credits claimed with respect to the master recording activity are not allowable because the activity was not engaged in for profit and there was no income received from the activity during the years in issue. He computed the amount attributable to the master recording items as follows:

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1977

	Amount Properly Reportable	Amount Properly Reportable Without Regard to Tax-Motivated Transaction
Adjustments		
Subchapter S Loss	$ 5,277	$ 5,277
Master Recording	2,925	
Total	$ 8,202	$ 5,277
Taxable Income As Previously Adjusted	37,429	37,429
Revised Taxable Income	$ 45,631	$ 42,706
Tax from Tax Rates	13,307	11,918
Less credits		
General Tax Credit	(180)	(180)
Investment Credit	(256)(1)	(11,256)(2)
Balance	$ 12,871	$ 482
Plus: Tax from recomputing prior year investment credit(1)	179	179
Total Correct Tax Liability	$ 13,050	$ 661
Total Tax Shown on Return or as Previously Adjusted	179	179
Increase in Tax	$ 12,871	$ 482

(1) As previously agreed—Spring Valley Farms Partnership.

(2) Per return in full $ 11,000
Additional agreed 256
Total 11,256

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1978

	Amount Properly Reportable	Amount Properly Reportable Without Regard to Tax-Motivated Transaction
Adjustments		
Subchapter S Loss	$ 6,855	$ 6,855
Master Recording	15,839	
Total	$ 22,694	$ 6,855
Taxable Income As Previously Adjusted	22,429	22,429
Revised Taxable Income	$ 45,123	$ 29,284
Tax from Tax Rates	13,063	
Tax from Tax Tables		6,227(3)
Less credits		
General Tax Credit	(180)	
Investment Credit(1)	(500)	(500)
Contribution to Candidates	(10)	(10)
Balance	$ 12,373	$ 5,717
Plus: Tax from recomputing prior year investment credit(2)	801	801
Total Correct Tax Liability	$ 13,174	$ 6,518
Total Tax Shown on Return or as Previously Adjusted	4,274	4,274
Increase in Tax	$ 8,900	$ 2,244

(1) As previously agreed--Spring Valley Farms Partnership.
(2) As previously agreed.
(3) Tax Table Income: $29,284 + $1,500 = $30,784.

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1979

	Amount Properly Reportable	Amount Properly Reportable Without Regard to Tax-Motivated Transaction
Adjustments		
Subchapter S Loss	$ 14,561	$ 14,561
Master Recording	15,841	
Total	$ 30,402	$ 14,561
Taxable Income As Previously Adjusted	19,921	19,921
Revised Taxable Income	$ 50,323	$ 34,482
Tax from Tax Rates	14,936	
Tax from Tax Tables		7,894(2)
Less credits		
Investment Credit(1)	(337)	(337)
Balance	$ 14,599	$ 7,557
Plus: Tax from recomputing prior year investment credit(1)	342	342
Total Correct Tax Liability	$ 14,941	$ 7,899
Total Tax Shown on Return or as Previously Adjusted	4,498	4,498
Increase in Tax	$ 10,443	$ 3,401

(1) As previously agreed.
(2) Tax Table Income: $34,482 + $2,000 = $36,482.

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The above tables set forth the amount of the properly reportable tax liability in column one and the tax liability without regard to the tax motivated transaction in column two. The difference between the amount of the properly reportable tax liability and the tax liability without regard to the tax motivated transaction equals the following underpayments of tax attributable to the tax motivated transaction: $12,389 in 1977, $6,656 in 1978, and $7,042 in 1979. Because the underpayments attributable to the tax motivated transaction each exceed $1,000, a substantial underpayment attributable to a tax motivated transaction exists in taxable years 1977, 1978, and 1979 to which the 120 percent interest rate set forth in section 6621(d) applies after December 31, 1984.

Notwithstanding our comments at trial and respondent's detailed analysis, petitioners ignored the section 6621(d) issues in their briefs. Because petitioners have not given us any reason to reject these computations,

Decision will be entered in accordance with the above computations.

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ORIGINAL

T. C. Memo. 1986-217

UNITED STATES TAX COURT

LEE B. FISHER, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 26053-82. Filed May 29, 1986.

John W. Condon, Jr., for the petitioner.

Timothy M. Cotter, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

TANNENWALD, Judge: Respondent determined a deficiency of $23,056.60 in petitioner's Federal income tax for the taxable year 1978 and additions to tax of $2,305.66 under section 6651(a) and $5,166.78 under section 6653(a) of the Internal Revenue Code.[1] The issues for decision are whether petitioner (1) failed

[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954, as amended and in effect during the years in issue, and all Rule references are to the Rules of Practice and Procedure of this Court.

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to report on his Federal income tax return $32,938 in interest income received by him during the 1978 taxable year; (2) is liable for an addition to tax under section 6651(a) for the late filing of his 1978 return; and (3) is liable for an addition to tax for negligence under section 6653(a). We have combined our findings of fact and opinion in order to avoid unnecessary repetition.

Some of the facts have been stipulated and are so found.

Petitioner resided in Buffalo, New York at the time he filed his petition herein. Petitioner's 1978 Federal income tax return was filed on August 11, 1979 and was received by the Andover Service Center on August 15, 1979. In 1978, petitioner was credited with interest income of $1,148 by the Marine Midland Bank and of $34,654.29 and $2,764.07 (in Canadian funds) by the Canadian Imperial Bank of Commerce with respect to which $5,198.14 and $414.61, respectively (in Canadian funds) was withheld as non-resident tax and paid over to the Canadian government.[2]

On his 1978 return, petitioner reported $140,000 on line 20 as "other income." He gave no breakdown or description in respect of such income, but he did report the $140,000 as self-employment income on Schedule SE and paid the self-employment tax

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2 Petitioner has made no claim, either in his 1978 tax return or at any time during the proceedings herein for any foreign tax credit.

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thereon. His 1978 return contained no indication of interest income on line 9 or elsewhere. In fact, all other lines describing items of income were left blank.

At the trial, petitioner testified that the $140,000 included the above-mentioned interest income. He described the balance of the $140,000 in vague and general terms, claiming the Fifth Amendment with respect to any further testimony as to the composition of the $140,000. One other witness (a lawyer for petitioner, although not in this case) testified that he had advised petitioner to report his income for 1978 in this fashion on the basis of advice by an accountant whom the lawyer had consulted and who also testified.

At the trial, we admitted (over petitioner's objections) certain evidence relating to petitioner's interest income for 1975, 1976, and 1977 and the manner of reporting his income on his Federal income tax returns for these years. We think that this evidence is clearly relevant to evaluating the testimony relating to the claimed handling of petitioner's interest income for 1978. This is particularly the case in light of petitioner's refusal to give a breakdown of the sources of his other income for that year.

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A further examination of that evidence has revealed certain discrepancies which cast doubt on the testimony given at trial.[3] Thus, petitioner's 1975 return (on p. 1) showed only a figure of $11,800 of "other income" which he labelled (on p. 2) and reported as self-employment income on Form 1040 SE as "commissions" income. Consequently, he could not have included in that return $2,573.59 of interest income in Canada which it appears he received in that year.

In 1976, petitioner reported $1,457 as interest income from the Internal Revenue Service and the Marine Trust Co., and $15,500 of "other income" (on p. 1), which he also labelled (on p. 2) as "commissions" and reported as self-employment income on Form 1040 SE. Yet in 1976, he appears to have had $33,460.28 interest income in Canada, an amount far in excess of the gross income reported on his 1976 return. The 1976 pattern is repeated in 1977 except that the "other income" ($15,000) is not further labelled but is reported as self-employment income on Form 1040 SE; in 1977, petitioner appears to have had $39,251.32 interest

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In light of this further examination, we will no longer, as we did at trial, characterize this evidence as equivocal. However, in view of the nature of petitioner's income producing activities, we have determined that his failure to file Department of the Treasury Forms 90-22.1 (Report of Foreign Bank and Financial Accounts) has been satisfactorily explained and we have not attached any significance to this failure.

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income in Canada, an amount far in excess of the gross income reported on his return.[4]

The foregoing pattern clearly indicates that, based upon the handling of the reporting of his income in prior years, petitioner may well not have included in the $140,000 "other income" reported for 1978, the interest income which respondent determined was omitted.

The burden of proof is on petitioner as to all issues herein. Rule 142(a). His claim of the privilege against self incrimination does not relieve him of that burden. United States v. Rylander, 460 U.S. 752, 758-759 (1983); Steinbrecher v. Commissioner, 712 F.2d 195, 198 (5th Cir. 1983), affg. a Memorandum Opinion of this Court. Nor, under the circumstances herein, are we required to accept petitioner's self serving testimony or the testimony of the other witnesses whom we saw and heard. Quock Ting v. United States, 140 U.S. 417, 420-421 (1891); Fleischer v. Commissioner, 403 F.2d 403, 406 (2d Cir. 1968), affg. a Memorandum Opinion of this Court. We are far from satisfied that the testimony of petitioner's lawyer and the accountant sufficiently corroborates petitioner's testimony to establish a prima facie case. Moreover, we note that petitioner's refusal to testify as to the composition of the $140,000 "other income" effectively deprived respondent of the

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4 There is no indication that this excess could possibly have been accounted for by the differential in exchange rates between the Canadian and U.S. dollar. For example, in 1978, the Canadian dollar was worth approximately 90 U.S. cents.

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opportunity to refute petitioner's evidence by means of cross-examination or countervailing evidence. See Gerling International Insurance Co. v. Commissioner, 86 T.C. ___ (March 26, 1986) (slip opinion p. 18).

Reasoning, similar to that above, leads us also to hold that petitioner has failed to carry his burden of proof as to the addition to tax for negligence under section 6653(a). We reach the same conclusion as to the addition to tax for late filing of his 1978 return under section 6651(a); the record is totally devoid of any probative evidence justifying the delay beyond April 15, 1979.

Decision will be entered for the respondent.

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ORIGINAL

T. C. Memo. 1986-218

UNITED STATES TAX COURT

JOHN H. MILAM, JR., Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 30163-83. Filed May 29, 1986.

John H. Milam, Jr., pro se.

Vallerie Volesko, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

TANNENWALD, Judge: Respondent determined deficiencies against petitioner in the amount of $5,290.53 for the 1980 taxable year and $3,023 for the 1981 taxable year. The issues for decision are whether petitioner (1) was away from home during

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1980 and 1981 so as to be entitled to deduct travel and living expenses under section 162,[1] and (2) entitled to moving expenses for 1981 beyond those allowed by respondent.

FINDINGS OF FACT

Petitioner resided in Corona, New York at the time he filed his petition herein. He filed timely Federal income tax returns as a single person for the taxable years ending December 31, 1980 and 1981, respectively. His 1980 return listed Macon, North Carolina as his address.

Petitioner is a plumber by trade and was a member of Plumbers Union Local No. 2 during the taxable years in issue. The Union's office is located in New York, New York.

Petitioner lived and worked in the New York area during the period 1970 - 1976. Thereafter, having been unable to find work for which he was trained in the New York area, he sought and obtained work as a steam fitter/pipe fitter as follows:

Places of Employment	Dates Employed
Clow Darling Box 578 Thunder Bay, Ontario	08/76 - 11/76
Bechtel Company Ltd. Bag Service #6 Corunna, Ontario	11/76 - 12/76

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1 All section references are to the Internal Revenue Code of 1954, as amended and in effect during the years at issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

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Petro Chem Projects Ltd. 09/77 - 11/77
P.O. Box 90
Terrace Bay, Ontario

TVA Watts Bar Nuclear Plant 07/78 - 05/80
P.O. Box 2000
Spring City, Tennessee

Bechtel Petroleum 06/80 - 03/81
P.O. Box 20140
Philadelphia, Pennsylvania

Hydraulic Plumbing & Heating 04/81 - Present
215-45 Northern Blvd.
Bayside, New York

Prior to 1981, petitioner's wife (from whom he was divorced in April 1981) and two children lived in the New York area. At some point in 1980 while petitioner was working in Spring City, Tennessee, he moved them to Woodbridge, Virginia which was 550 miles from Spring City but closer to Spring City than New York.

During the period when he worked for the Tennessee Valley Authority, petitioner lived in an apartment in the vicinity of Spring City, Tennessee. During the period when he worked for Bechtel Petroleum, petitioner lived in a motor lodge in Mount Laurel, New Jersey, which is in the vicinity of Philadelphia.

Petitioner did not maintain an apartment or any place of abode in New York during 1980 and until August 1981 when he took up New York residence in connection with his current employment.

Petitioner incurred moving expenses of $1,975 in moving from New Jersey to New York in 1981.

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OPINION

Section 162(a) permits a taxpayer to deduct "traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business." The burden of proving that he is entitled to deduct his claimed living expenses while working in Spring City and Philadelphia is on petitioner. Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a).

The threshold question is whether petitioner maintained a home from which he was away during 1980 and 1981.

Petitioner's contacts with the New York area were practically nonexistent during the taxable year 1980 and that portion of 1981 while he was working in Philadelphia. He maintained no place of abode in the New York area. He moved his wife (from whom he was apparently separated and later divorced) and his children to Woodbridge, Virginia sometime in 1980--a fact, which we think is a strong indication that New York was no longer his home. The only connection of petitioner with the New York area is his membership in the union and his apparent subjective intention to return to New York as and when the opportunity for employment there presented itself.

Under all the circumstances, we are unable to conclude that petitioner's tax home was at a place other than where he worked during 1980 and 1981. Rosenspan v. United States, 438 F.2d 905

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(2d Cir. 1971); Barone v. Commissioner, 85 T.C. 462 (1985), on appeal (9th Cir., Jan. 13, 1986); Hicks v. Commissioner, 47 T.C. 71 (1966). The fact that petitioner did not maintain a place of abode in New York is most significant and distinguishes Schurer v. Commissioner, 3 T.C. 544 (1944) and the other cases upon which petitioner relies. See also Rambo v. Commissioner, 69 T.C. 920 (1978). Moreover, in view of his separation and divorce, petitioner's expenditures for maintenance of his wife and children do not represent duplicate expenses which should be taken into account. Gleeson v. Commissioner, T.C. Memo. 1985-404. Petitioner's maintenance of union membership in the New York local is far from sufficient to tip the scale in petitioner's favor. The same is true with respect to petitioner's subjective intent. Barone v. Commissioner, supra at 465; Hicks v. Commissioner, supra at 73.

In view of our conclusion that petitioner was not "away from home," we have no need to consider whether his employment in Spring City and Philadelphia was temporary or indefinite.

As far as petitioner's moving expenses in 1981 are concerned, the only issue for decision is that of substantiation. Respondent allowed petitioner $1,475 of the claimed deduction of $3,128. We think that petitioner is entitled to an additional deduction of $500 for room and meals and we so hold. We note

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that the breakdown of the $1,475 allowed by respondent discloses that this additional allowance will not cause the $1,500 limitation of section 217(b)(3)(A) to be exceeded.

Decision will be entered under Rule 155.

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T. C. Memo. 1986-219

UNITED STATES TAX COURT

HERMINE ZAMBAKIAN AND IRVING ZAMBAKIAN,
Petitioners v. COMMISSIONER OF
INTERNAL REVENUE, Respondent

Docket No. 1253-84. Filed June 2, 1986.

During 1981, Ps maintained brokerage accounts on which they paid interest and from which they received interest and dividend income. In computing their 1981 tax liability, Ps did not consider the alternative minimum tax imposed by section 55, I.R.C. Held, because Ps were not engaged in the trade or business of investing, Ps' investment interest expenses are deductible as itemized deductions under section 163, I.R.C. These expenses are therefore includable in Ps' 1981 alternative minimum taxable income.

Irving Zambakian, pro se.

Richard F. Flaherty, for the respondent.

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MEMORANDUM OPINION

NIMS, Judge: Respondent determined a deficiency of $1,696.40 in petitioners' 1981 Federal income tax. The sole issue for decision is whether petitioners are subject to the alternative minimum tax imposed by section 55[1] as determined by respondent. Resolution of this issue turns on whether Irving Zambakian's investment activities during 1981 constituted a trade or business.

The case was submitted fully stipulated. The stipulation of facts and attached exhibits are incorporated herein by this reference.

Petitioners Irving Zambakian (hereinafter sometimes referred to as Irving or petitioner) and Hermine Zambakian (Hermine), husband and wife, resided at Glen Ridge, New Jersey, at the time they filed the petition herein.

During 1981, petitioners maintained brokerage accounts on which they paid interest and from which they received interest and dividend income. Irving and Hermine jointly filed a 1981 Form 1040 on which they listed their occupations as "investor" and "homemaker," respectively. On their 1981 Form 1040, they reported adjusted gross income of $6,629 determined as follows:

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[1] Unless otherwise indicated, all section references are to sections of the Internal Revenue Code of 1954 in effect for the year in question.

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wage income--0; interest and dividend income--0[2]; capital loss--$3,000; and rents, royalties, partnerships, etc.--$9,629. From adjusted gross income of $6,629, petitioners subtracted excess itemized deductions of $2,826 and exemptions of $3,000 to arrive at taxable income of $803. Based on taxable income of $803, petitioners determined that they owed no Federal income tax for taxable year 1981. Petitioners, however, did not consider the alternative minimum tax provisions of section 55 in determining their 1981 tax liability.

On Schedule B (Interest and Dividend Income) attached to their 1981 Form 1040, petitioners reported interest income of $2,679 and dividend income of $94,840. Petitioners offset the dividend income by investment interest expenses of $165,157.

On Schedule D (Capital Gains and Losses) of their 1981 income tax return, petitioners reported net short-term capital losses of $33,648[3] and net long-term capital losses of $56,099.[4] On an attachment to Schedule D of their 1981 return, petitioners reported the following stock transactions:

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[2] On lines 8(a) and 8(b) of their 1981 Form 1040, petitioners reported interest income of $2,679 and "negative" dividends of $70,192. In determining the amount of dividend income, petitioners offset dividend income of $94,840 by investment interest expenses of $165,157.

[3] This amount included a short-term capital loss carryover of $37,170.

[4] This amount included a long-term capital loss carryover of $76,048.

Stock	Date of Purchase	Date of Sale	Long-Term Capital Gain (or Loss)	Short-Term Capital Gain (or Loss)
Continental Airlines	9/3/65	3/9/81	$ 322	$ -
Candel Oil	4/1/60	4/22/81 and 5/5/81	4,502	-
Barth Spencer	4/6/71 and 7/7/72	6/20/81	(1,043)	-
Mobil Corp.	7/14/80	7/13/81	-	(1,571)
El Paso Corp.	12/12/79	7/13/81	(71)	-
Conoco, Inc.	7/29/81	8/7/81	-	310
Iowa Beef	9/12/75	8/11/81	19,895	-
Santa Fe International	2/4/81	12/21/81	-	4,783
Houston Oil	10/30/78	1/5/81	2,160	-
Houston Oil	5/16/77, 7/15/77 and 10/20/78	4/28/81	(5,816)	-
TOTAL			$19,949	$3,522

On Schedule E (Supplemental Income Schedule) attached to their 1981 Form 1040, petitioners reported rental income of $10,969 from the following investment properties: (1) a garage located in Westminster, Colorado; (2) a parking lot located in Denver, Colorado; and (3) certain land located in Arkansas. Petitioners also reported a partnership loss of $1,340 on this schedule.

In the notice of deficiency, respondent allowed as itemized deductions petitioners' investment interest expenses to the extent of $107,119. Respondent further determined that these expenses were includable in petitioners' alternative minimum taxable income for 1981 as a tax preference item. Respondent therefore determined that petitioners were liable for the alternative minimum tax imposed by section 55 in the amount of $1,696.40.

The sole isue for decision is whether petitioners are liable for the alternative minimum tax imposed by section 55 as determined by respondent. For the year in issue, section 55 provided in pertinent part:

> SEC. 55. ALTERNATIVE MINIMUM TAX FOR TAXPAYERS OTHER THAN CORPORATIONS
>
> (a) ALTERNATIVE MINIMUM TAX IMPOSED.--In the case of a taxpayer other than a corporation, if--
>
> (1) an amount equal to the sum of--
>
> (A) 10 percent of so much of the alternative minimum taxable income as exceeds $20,000 but does not exceed $60,000 plus
>
> (B) 20 percent of so much of the alternative minimum taxable income as exceeds $60,000 but does not exceed $100,000, plus
>
> (C) 25 percent of so much of the alternative minimum taxable income as exceeds $100,000, exceeds
>
> (2) the regular tax for the taxable year,
>
> then there is imposed (in addition to all other taxes imposed by this title) a tax equal to the amount of such excess.
>
> (b) DEFINITIONS.--For purposes of this section--
>
> (1) ALTERNATIVE MINIMUM TAXABALE INCOME.--The term "alternative minimum taxable income" means gross income--
>
> (A) reduced by the sum of the deductions allowed for the taxable year,
>
> (B) reduced by the sum of any amounts included in income under section 86 or 667, and
>
> (C) increased by an amount equal to the sum of the tax preference items for--

> (i) adjusted itemized deductions (within the meaning of section 57(a)(1)), and
>
> (ii) capital gains (within the meaning of section 57(a)(9)).
>
> * * *

For purposes of defining adjusted itemized deductions, section 57(a)(1) refers to section 57(b)(1) which provides as follows:

> (b) ADJUSTED ITEMIZED DEDUCTIONS.--
>
> (1) IN GENERAL.--For purposes of paragraph (1) of subsection (a), the amount of the adjusted itemized deductions for any taxable year is the amount by which the sum of the itemized deductions (as defined in section 63(f)) other than--
>
> (A) the deduction for State and local, and foreign taxes provided by section 164(a),
>
> (B) the deduction for medical, dental, etc., expenses provided by section 213,
>
> (C) the deduction for casualty losses described in section 165(c)(3), and
>
> (D) the deduction allowable under section 691(c),
>
> exceeds 60 percent of the taxpayer's adjusted gross income reduced by the items in subparagraphs (A) through (D) for the taxable year.

Petitioners argue that during 1981 they were engaged in the trade or business of investing, and, therefore, the investment interest expenses they incurred during 1981 were ordinary and necessary business expenses under section 162. Petitioners further argue that because section 162 deductions are not tax preference items, their investment interest expenses should not be included in

alternative minimum taxable income. Petitioners conclude that if their investment interest expenses for 1981 are excluded from alternative minimum taxable income, they are not liable for any alternative minimum tax in 1981.

Respondent agrees that petitioners are not liable for any alternative minimum tax if their investment interest expenses are deductible as ordinary and necessary business expenses under section 162. Respondent maintains, however, that petitioners' investment activities did not rise to the level of a trade or business during 1981, and, therefore, that petitioners' investment interest expenses are properly deductible as itemized deductions under section 163(a).[5] Respondent further maintains that as an itemized deduction, petitioners' investment interest expenses constitute a tax preference item which must be included in alternative minimum taxable income. Petitioners do not dispute respondent's disallowance of some of their investment interest expenses for 1981. The issue we must decide, therefore, is whether petitioners' investment activities rose to the level of a trade or business during 1981.

In determining whether a taxpayer who manages his own investments is engaged in a trade or business, the courts have distinguished between "traders" and "investors." It has been held that taxpayers who are security traders are considered to be

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[5] Section 163(a) provides that "[t]here shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness."

engaged in a trade or business. Moller v. United States, 721 F.2d 810 (Fed. Cir. 1983). However, taxpayers who are simply investors in the stock market are not considered to be engaged in a trade or business, notwithstanding the frequency, extent and regularity of their investment activity. Higgins v. Commissioner, 312 U.S. 212 (1941); see Moller v. United States, supra.

In Liang v. Commissioner, 23 T.C. 1040, 1043 (1955), this Court distinguished between investment and trading accounts as follows:

> [I]n the former, securities are purchased to be held for capital appreciation and income, usually without regard to short-term developments that would influence the price of the securities on the daily market. In a trading account, securities are bought and sold with reasonable frequency in an endeavor to catch the swings in the daily market movements and profit thereby on a short-term basis.

Relying on this language, the Court of Appeals for the Federal Circuit made the following distinction between a trader and an investor:

> [I]n order to be a trader, a taxpayer's activities must be directed to short-term trading, not the long-term holding of investments, and income must be principally derived from the sale of securities rather than from dividends and interest paid on those securities. [Moller v. United States, 721 F.2d at 813.]

Applying the above definitions to the facts of this case, we find that during 1981 petitioners were investors rather than traders. During 1981, petitioners received dividend and interest income of $97,519 as compared to net gains of $23,471 on the sale of securities. Thus, during 1981, petitioners' gross income was

principally derived from dividend and interest income rather than from the sale of securities. Moreover, during 1981, petitioners engaged only in two security purchase transactions and eleven sales transactions. The infrequency of petitioners' stock trades during 1981 belies any notion that petitioners' investment activities were directed toward short-term trading on daily market movements. Indeed, taxpayers who previously have been found to be in the business of trading stock on their own account generally engaged in market transactions on an almost daily basis. See Levin v. United States, 597 F.2d 760, 765 (Ct. Cl. 1979); Fuld v. Commissioner, 139 F.2d 465 (2d Cir. 1943).

We also note that nine of the eleven sales transactions which occurred during 1981 involved shares of stock which petitioners had held for periods ranging from 1 year to 21 years. The length of time petitioners held their stock is additional evidence that their investment activities were directed toward long-term holding of investments rather than short-term trading. Purvis v. Commissioner, 530 F.2d 1332 (9th Cir. 1976), affg. per curiam T.C. Memo. 1974-164.

Consequently, we are satisfied that petitioners' selling activities during 1981 were primarily directed to long-term holding of investments and the production of dividend and interest income rather than short-term trading. We therefore find that petitioners were investors in the stock market and were not in business as stock and securities traders during 1981. Under these

circumstances, petitioners' interest expenses constitute a tax preference item for purposes of the section 55 alternative minimum tax.

To reflect the foregoing,

Decision will be entered for the respondent.

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T. C. Memo. 1986-220

UNITED STATES TAX COURT

MARCELLUS S. DEATS, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 41523-84. Filed June 2, 1986.

Marcellus S. Deats, pro se.

Albert B. Kerkhove, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

COUVILLION, Special Trial Judge: This case was assigned pursuant to the provisions of section 7456(d) of the Code[1] and Rules 180, 181, and 182.

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1 All section references are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated; and all Rule references are to the Tax Court Rules of Practice and Procedure.

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Respondent determined a deficiency in petitioner's Federal income tax for the year 1982 in the amount of $5,153, additions to the tax in the amount of $827, under section 6651(a); $258, under section 6653(a)(1); 50 percent of the interest due on $3,308 under section 6653(a)(2); and $276, under section 6654.

The issues for decision are: (1) Whether compensation earned by petitioner in 1982 in his capacity as a public employee is taxable; (2) whether petitioner is entitled to certain exemptions; and (3) whether petitioner is liable for additions to tax for delinquency, negligence, and failure to pay estimated tax. In addressing the last issue, we must decide (inter alia) whether a particular Form 1040 constitutes a retu

FINDINGS OF FACT

Some of the facts have been stipulated. The stipulation of facts and attached exhibits are incorporated herein by reference.

Petitioner and his wife resided in Omaha, Nebraska, at the time the petition herein was filed.

During 1982, petitioner was employed by the City of Omaha. For that year, he and his wife filed a Form 1040 in which they set forth their names, address, social security numbers, an election to file a joint return, and a claim of two personal and seven dependency exemptions. Petitioner and his wife dated the form and signed it under penalties of perjury. Gross income of $63.23 in interest was reported. On line 7 ("Wages, salaries, tips, etc."), petitioner entered the figure "0" but attached a

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Wage & Tax Statement (W-2 Form) showing wages of $22,428.89 paid to him during 1982 by the City of Omaha and another W-2 Form showing wages of $15.18 paid to his wife during that year by a private employer. Petitioner's Form 1040 reported "0" tax liability.

Respondent contends that petitioner's wages constitute taxable income. Respondent also contends that the Form 1040 filed by petitioner and his wife does not constitute a return. Accordingly, in determining the deficiency, respondent allowed petitioner only one exemption and used the rates for married individuals filing separately.

OPINION

Petitioner's contention that his wages are exempt from tax under the Public Salary Tax Act of 1939 is without merit. Although compensation earned by public officers of state and local governments was originally thought to be exempt from Federal income tax, the Supreme Court held to the contrary in 1938. Helvering v. Gerhardt, 304 U.S. 405 (1938). Shortly thereafter, Congress enacted the Public Salary Tax Act of 1939, 53 Stat. 574. That act provided, inter alia, for the abatement, credit, or refund of income taxes on the compensation of state officers and employees which had been earned prior to 1938. However, the act did not create any prospective exemption from Federal income tax but rather merely preserved the exemption that had existed prior to Helvering v. Gerhardt. See Belser v.

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Commissioner, 10 T.C. 1031, 1040-1041 (1948), affd. 174 F.2d 386 (4th Cir. 1949), cert. denied 338 U.S. 893 (1949).

We turn now to the issue whether the Form 1040 filed by petitioner and his wife constitutes a return. Admittedly this matter is not free from doubt. However, on balance, we conclude the form constitutes a return. This being the case, it follows that (1) petitioner is entitled to (a) personal exemptions for his wife and himself and (b) joint return rates; and (2) petitioner is not liable for the delinquency addition under section 6651(a)(1) for failure to file a return.

Petitioner presented no evidence to establish his entitlement to the seven dependency exemptions which he originally claimed.[2] Accordingly, we sustain respondent's disallowance of those exemptions. Rule 142(a). Petitioner similarly failed to carry his burden of proof as to the negligence addition under section 6653(a)(1) and (2), and we therefore sustain respondent's determination. Bixby v. Commissioner, 58 T.C. 757, 791-792 (1972). Finally, we hold that petitioner is liable for the addition to tax under section 6654 for failure to pay estimated tax. The addition under that section is automatic absent exceptions that petitioner has not

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2 Petitioner and Mrs. Deats were asked several times whether they had additional information to present but were too preoccupied with their frivolous challenges to the proceedings to present relevant evidence.

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shown to be applicable in this case. Grosshandler v. Commissioner, 75 T.C. 1, 20-21 (1980).

We have considered other contentions advanced by petitioner and find them without merit.

Decision will be entered under Rule 155.

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T. C. Memo. 1986-221

UNITED STATES TAX COURT

MARCELLUS S. and BARBARA L. DEATS, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 5551-85. Filed June 2, 1986.

Marcellus S. and Barbara L. Deats, pro se.

Albert B. Kerkhove, for the respondent.

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MEMORANDUM FINDINGS OF FACT AND OPINION

COHEN, Judge: Respondent determined deficiencies in and additions to petitioners' Federal income taxes for 1983 as follows:

Year	Deficiency	Additions to Tax Sec. 6651(a)[1]	Sec. 6653(a)(1)	Sec. 6653(a)(2)	Sec. 6654
Marcellus S. Deats					
1983	$5,997.00	$949.00	$300.00	*	$ 200.00
Barbara L. Deats					
1983	2,053.00	513.00	103.00	**	126.00

* 50 percent of the interest due on $3,796.00
** 50 percent of the interest due on $2,053.00.

The only bona fide issue is whether petitioners are entitled to business expenses and personal exemptions beyond those allowed by respondent.

FINDINGS OF FACT

Petitioners were residents of Omaha, Nebraska, at the time they filed their petition herein. They did not file Federal income tax returns for 1983.

During 1983, petitioner Marcellus S. Deats was employed by the City of Omaha and earned wages totaling $25,978. During 1983, petitioner Barbara L. Deats earned income by preparing tax returns for others.

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[1] Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1954, as amended and in effect during the year in issue.

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In the statutory notice of deficiency sent to Mrs. Deats, respondent determined that Mrs. Deats had gross business income of $10,000, based on preparation of 400 returns at $25 each. The reconstructed amount of income was based on statements made by Mrs. Deats to another individual, who reported those statements to respondent's agent. Respondent did not allow any business deductions because none were substantiated by petitioners.

Petitioners are the parents of four unmarried children born in 1957, 1965, 1966, and 1970. These four children lived with petitioners and were supported by Mr. Deats during all of 1983. Their married daughter Susan Fisher, her husband and two small children lived with petitioners part of 1983 after Mr. Fisher lost his job.

OPINION

When the case was called for trial, petitioners filed a trial memorandum in which they set forth various frivolous tax protester arguments and a chronology purportedly showing that they had been mistreated by the Internal Revenue Service. In their petition and at trial, they stated that they had not filed tax returns for 1983 because they were awaiting a determination of the validity of purported amended returns filed by them for 1981 and 1982.[2] The thrust of their arguments is that Mr. Deats' wages are not income and that Mrs. Deats did not profit from the

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[2] Mr. Deats' liability for 1982 is at issue in docket No. 41523-84, tried February 10, 1986, 5 weeks prior to the trial in this case.

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tax return preparation activity engaged in by her during 1983. The former argument repeatedly has been held to be frivolous by this Court and by the Court of Appeals for the Eighth Circuit, to which this case is appealable. See, e.g., Hayward v. Commissioner, 746 F.2d 1369 (8th Cir. 1984), affg. a Memorandum Opinion of this Court; Hanson v. United States, 744 F.2d 658, 660 (8th Cir. 1984); Hayward v. Day, 619 F.2d 716, 717 (8th Cir. 1980), affg. a criminal conviction of a taxpayer making such contentions; Rowlee v. Commissioner, 80 T.C. 1111, 1119-1122 (1983), sustaining an addition to tax for fraud against a taxpayer making such contentions.

Under the circumstances, respondent's reconstruction of Mrs. Deats' income is appropriate. See Denison v. Commissioner, 751 F.2d 241, 242 (8th Cir. 1984), affg. a Memorandum Opinion of this Court. Petitioners have the burden of proving that they are entitled to deductions against that income. New Colonial Ice Co. v. Helvering, 292 U.S. 435 (1934), Rule 142(a), Tax Court Rules of Practice and Procedure.

Mrs. Deats did not dispute the amount of payments received for tax returns prepared by her during 1983. She argues that she had no income because money beyond reimbursement of expenses was paid into the bank account of an entity known as F.A.C.T. (Fair and Constitutional Tax), which was "an account that our clients wished to use for future tax situations." Mrs. Deats conceded that she and her sister had signatory control over the bank account. She has failed to prove that the sums received by her

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belonged to another or were not taxable compensation for her services. Section 61.

Mrs. Deats testified that sums were paid out of the account for attorneys' fees and that expenses were incurred for supplies and similar business expenses. She did not, however, produce any records that would show specific payments made or the purpose of any such payment. It is probable that Mrs. Deats did incur office expenses in relation to the tax preparation service that she operated. We use our best judgment to approximate the amount of those expenses, bearing heavily against the taxpayer who failed to keep or produce records substantiating those expenses. See Cohan v. Commissioner, 39 F.2d 540 (2d Cir. 1930). We conclude that Mrs. Deats is entitled to a deduction for business expenses of $1,000. Respondent's determination of her taxable income must otherwise be sustained.

Mr. Deats testified that he provided a home and support for his five children, his son-in-law, and his two small grandchildren during 1983. Three of those children were under 19 in 1983. He testified that the fourth, although an adult, had minimal, if any, employment or income during that year. We accept Mr. Deats' testimony and conclude that he provided more than one-half of the support of and is entitled to dependency

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exemptions for each of these four children for 1983. See sections 151(e), 152(a).[3]

With respect to petitioners' married daughter and her family, however, petitioner did not produce evidence making it more likely than not that he provided more than half the support of those individuals for the taxable year, a prerequisite to allowance of the dependency exemption. Section 152(a). Moreover, he did not show that his married daughter did not make a joint return with her spouse, which could result in denial of the exemption. Section 151(e)(2). Exemptions cannot be allowed, therefore, for the Fisher family.

Petitioners claimed at trial, in March 1986, that they had not filed their tax returns for 1983 because they were awaiting determination of their obligations to file for 1981 and 1982. Their argument is totally lacking in merit, and they have not shown reasonable cause for their failure to file returns. Moreover, their testimony merely supports respondent's determination that their failure to file was due to negligence or intentional disregard of rules and regulations. The additions to tax under sections 6651(a) and 6653(a) are sustained. The additions to tax under section 6654 are automatic absent exceptions that petitioners have not shown to be applicable in

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[3] Mr. Deats failed to provide any such evidence in his earlier case, note 2, supra, and could, therefore, not be allowed exemptions for 1981 or 1982. See T.C. Memo. 1986-220.

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this case. Grosshandler v. Commissioner, 75 T.C. 1, 20-21 (1980).

Decision will be entered under Rule 155.

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T. C. Memo. 1986-222

UNITED STATES TAX COURT

ALAN FRANK AND BARBARA FRANK, Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 5430-83. Filed June 2, 1986.

Alan Frank, pro se.

Donna J. Pankowski, for the respondent.

MEMORANDUM OPINION

SHIELDS, Judge: Respondent determined a deficiency in petitioners' 1977 Federal income tax in the amount of $13,410 and an addition to tax under section 6653(a)[1] in the amount of $671. After concessions by petitioners,[2] the issues for decision are:

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1 All section references are to the Internal Revenue Code of 1954, as amended, during the year in issue unless otherwise indicated. All rule references are to the Tax Court Rules of Practice and Procedure unless otherwise provided.

2 At trial, petitioners abandoned all issues except those set forth above. The concession included respondent's negligence determination under section 6653(a).

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(1) whether petitioners received unreported income in the amount of $17,150; and (2) whether petitioners are entitled to a business bad debt deduction under section 166.

For convenience, our findings of fact and opinion are combined. Some of the facts were orally stipulated at trial and are so found, as are additional facts which were deemed admitted under Rule 90 pursuant to an order dated February 22, 1984.

Petitioners resided in Pittsburgh, Pennsylvania at the time their petition was filed. They filed a joint income tax return for the year 1977 with the Philadelphia Service Center.

Alan Frank has been a lawyer since about 1963. At the time of trial he was a member of the firm of Frank and Radakovich.

In the mid 1970's, petitioner also became a stockbroker and with two other individuals organized T.M.F., Inc. to trade in common stocks. The stockholders and directors of T.M.F. never had any formal meetings and never maintained any corporate or accounting books and records. However, with endorsements by one or more of its stockholders the corporation borrowed substantial sums from two local banks, Pittsburgh National Bank and Equibank, N.A.

By early 1976 T.M.F. was unable to meet its financial obligations and ceased operations. On February 27, 1976, Pittsburgh National Bank obtained a judgment against petitioners in the approximate amount of $25,000 on one of the loans made by the bank to T.M.F. Petitioners paid this judgment by August 16, 1976 from the proceeds of a second mortgage on their home.

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On December 20, 1977, Alan Frank paid $17,150 in cash to Equibank in order to obtain the release of four bonds pledged to secure a demand note of T.M.F. on which the principal balance due at that time was $29,758.91. Respondent determined that the $17,150 payment was made from unreported income. Petitioners contend that it was not made from unreported income but instead was made from the proceeds of a loan. Respondent's determination is presumptively correct and petitioners have the burden of proving otherwise. Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a).

At trial, Alan Frank testified that the $17,150 was loaned to him by a personal friend so that he could make the payment on the T.M.F. note. He stated that the friend, Joe Litman, advanced the money without ever being asked and that the advance was made by means of a "bag full of cash." Frank further testified that Litman was repaid the full $17,150 in cash without interest in March of 1979 from Frank's part of the settlement of a legal action brought by Frank and Radakovich against an unrelated third party.

We are unable to accept Frank's uncorroborated testimony at trial primarily because it is contrary to the weight of the evidence and it is contradicted to some extent by his own statements on brief and to respondent's agents. In fact, we find petitioner's entire testimony to be vague, conflicting and totally unreliable.

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Initially we note that prior to trial Frank refused to disclose to respondent's representatives the name of the alleged lender maintaining that he had promised never to tell anyone where the money came from. At trial, however, he claimed the lender was the by then deceased Joe Litman and testified that he was never specifically requested to keep the loan a secret but had done so on his own accord. He further testified that he could then reveal Mr. Litman's name because Litman was deceased.

Next we note that at trial Frank testified that he received only $17,150 from Litman but on brief he asserts that he borrowed "$20,000.00 in cash from a personal friend." Also at trial, Frank testified that the cash allegedly used to repay Litman was derived from a personal check, made payable to Zach Pilossoph, in the amount of $20,000 which he cashed on March 12, 1979. He was unable to produce the check. Respondent, however, produced a copy of the front of a check dated March 12, 1979 and signed by Frank on which the name of the payee had been obliterated. The copy with the payee's name already obliterated had been submitted by Frank to respondent's appellate officer with the explanation that the payee was the lender and his name had been deleted in order to conceal his identity. Petitioner also told the appellate officer that the entire $20,000 was given to the lender as repayment for the loan.

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We find the inconsistencies and contradictions set forth above to be a clear indication of Frank's lack of trustworthiness and of his ability to freely change his testimony to best suit his needs. Further evidence of his lack of credibility appears in such statements made by him at trial as the following:

> WITNESS: * * * I know I made statements from the Appellant's standpoint at that point [appellate office] which were somewhat testing of the truth. I did not want to reveal the name of Joe Litman, never did and never would have. And I'm sure that I did anything I could to try and get a settlement as best I could with Mr. Paterra, and I may well have indeed said anything about the name of the payee * * *.

The record before us contains a number of other conflicting statements and facts which tend to further impeach Frank's testimony. For instance, at one point he testified that in 1977 he could not have had earnings to the extent of $17,000. However, on his tax return for that year he reported gross receipts from the law practice of over $79,000 and net profits of over $22,000. Furthermore, he repeatedly stated that he had never dealt with the Internal Revenue Service prior to the commencement of this matter, but subsequently admitted to having been involved in a previous case when confronted with the appeals officer in that matter.

Finally, we note that even though he had failed to fully comply with Rule 91 regarding stipulations prior to trial, at the request of Frank, the record was left open after the trial, in order to permit petitioners to introduce the original of the $20,000 check dated March 12, 1979 and the testimony of Zach Pilossoph and Frank's former partners. Since no such evidence

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was produced we conclude that if produced it would not have been favorable to petitioners' position. Wichita Terminal Elevator Co. v. Commissioner, 6 T.C. 1158 (1946), affd. 162 F.2d 513 (10th Cir. 1947).

Since we find Frank's testimony incredible and unworthy of belief and since we have been shown no other proof to the contrary, respondent's determination that the $17,150 is unreported income is sustained.

With respect to the bad debt issue, we find that for 1977 petitioner reported gross profits from legal services of $79,110 and expenses of $56,974 for a net profit from his law practice of $22,136. Among the expenses claimed was a deduction of $18,633 for business bad debts. Respondent disallowed the deduction in its entirety after determining that the $18,633 consisted of:

(1) the nonbusiness bad debt of the $17,150 ($16,894 principal and $256 interest) paid by Frank to Equibank;

(2) a capital contribution of $1,275 resulting from a transfer of that amount from petitioners' personal account to T.M.F.'s checking account; and

(3) a nondeductible expense of $208.

At trial, Frank contended that a business bad debt resulted from his payments made in 1977 on corporate notes of T.M.F.[3]

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[3] Pursuant to section 166(d)(2), a debt is a nonbusiness bad debt if it is other than "(A) a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or (B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business."

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However, the record contains no evidence on this issue, it is not discussed in petitioners' brief, and is deemed abandoned by petitioners.

Decision will be entered for respondent.

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